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[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and Senate Committee on Finance, provides an explanation of tax legislation enacted in the 104th Congress. The explanation follows the chronological order of the tax legislation as signed into law.

A committee report on legislation issued by a Congressional committee sets forth the committee's explanation of the bill as it was reported by that committee. In some instances, a committee report does not serve as an explanation of the final provisions of the legislation as enacted. This is because the version of the bill enacted after action by the Conference Committee may differ significantly from the versions of the bill reported by the House and Senate Committees and passed by the House and Senate. The material contained in this pamphlet is prepared so that Members of Congress, tax practitioners, and other interested parties can have an explanation of the final tax bills enacted in the 104th Congress.

Part One of the pamphlet is an explanation of the provisions of H.R. 831 (P.L. 104-7) relating to the deduction for self-employed health insurance and repeal of Code section 1071. Part Two is an explanation of H.R. 2778 (P.L. 104-117) relating to tax benefits for individuals performing services in certain hazardous duty areas. Part Three is an explanation of the Taxpayer Bill of Rights 2 (H.R. 2337, P.L. 104-268). Part Four is an explanation of the revenue provisions of the Small Business Job Protection Act of 1996 (H.R. 3448, P.L. 104-188). Part Five is an explanation of the revenue provisions of the Health Insurance Portability and Accountability Act of 1996 (H.R. 3103, P.L. 104-191). Part Six is an explanation of the revenue provisions (relating to the earned income credit) of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (H.R. 3734, P.L. 104-193). Part Seven is an explanation of the revenue provision (relating to the tax treatment of special assessments for the Savings Association Insurance Fund) of the fiscal year 1997 Continuing Appropriations Bill (H.R. 3610, P.L. 104-208). The Appendix provides estimates of the budget effects of tax legislation enacted in the 104th Congress.

The first footnote in each part gives the legislative history of each of the Acts.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS–12–6), December 18, 1996.

PART ONE:

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION; REPEAL OF SECTION 1071 (H.R. 831)[2]

A. Permanently Extend and Increase Deduction for Health Insurance Costs of Self-Employed Individuals (sec. 1 of H.R. 831 and sec. 162(l) of the Code)

Present and Prior Law

Under present and prior law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income. The exclusion is generally available in the case of owners of a business who are also employees.

In the case of self-employed individuals (i.e., sole proprietors or partners in a partnership), prior law provided a deduction for 25 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 25-percent deduction was available with respect to the cost of selfinsurance as well as commercial insurance. In the case of self insurance, the deduction was not available unless the self-insured plan was in fact insurance (e.g., there was appropriate risk shifting) and not merely a reimbursement arrangement. The 25-percent deduction was not available for any month if the taxpayer was eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. In addition, no deduction was available to the extent that the deduction exceeded the taxpayer's earned income. The amount of expenses paid for health insurance in excess of the deductible amount could be taken into account in determining whether the individual was entitled to an itemized deduction for medical expenses. The 25-percent deduction expired for taxable years beginning after December 31, 1993.

[2] Public Law 104-7; signed on April 11, 1995.

H.R. 831 was reported by the House Committee on Ways and Means on February 14, 1995 (H. Rept. 104-32), and was passed by the House on February 21, 1995. H.R. 831, as amended, was reported by the Senate Committee on Finance on March 20, 1996 (S. Rept. 104-16), and was passed by the Senate on March 24, 1995. The conference report was filed on March 29, 1995 (H. Rept. 104-92), and was approved by the House on March 30, 1995 and by the Senate on April 3, 1995.

H.R. 831 (sec. 6) also included a required study by the staff of the Joint Committee on Taxation of issues related to the taxation of expatriation. The staff study was published on June 1, 1995: Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95). See Part Five of this pamphlet for an explanation of expatriation tax provisions in H.R. 3103 (P.L. 104-191).

For purposes of these rules, more than 2-percent shareholders of S corporations were treated the same as self-employed individuals. Thus, they were entitled to the 25-percent deduction.

Under present and prior law, other individuals who purchase their own health insurance (e.g., someone whose employer does not provide health insurance) can deduct their insurance premiums only to the extent that the premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

Reasons for Change

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

The Congress believed it was appropriate to continue to reduce the disparity between the tax treatment of health insurance expenses of owners of incorporated and unincorporated businesses. Further, the Congress believed that the pattern of allowing the deduction to expire and then extending it created unneeded uncertainty for taxpayers. The Congress concluded that the deduction should be made permanent.

In addition, the Congress believed that self-employed individuals should be entitled to a deduction for their health insurance expenses in the same manner as owners of incorporated businesses, and therefore the Congress found it appropriate to increase the level of the deduction from 25 to 30 percent, beginning in 1995.

Explanation of Provision

H.R. 831 retroactively reinstated the deduction for 25 percent of health insurance costs of self-employed individuals for taxable years beginning in 1994. H.R. 831 also extended the deduction permanently and increased the deduction to 30 percent for taxable years beginning after December 31, 1994.[3]

Effective Date

The provision generally was effective for taxable years beginning after December 31, 1993. The increase in the deduction to 30 percent of health insurance costs was effective for taxable years beginning after December 31, 1994.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $514 million in 1995, $482 million in 1996, $527 million in 1997, $587 million in 1998, $649 million in 1999, $708 million in 2000, $769 million in 2001, $834 million in 2002, $901 million

[3] The Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191, August 21, 1996) further increased the deduction for health insurance expenses of self-employed individuals. (See the discussion in Part Five of this pamphlet.)

in 2003, $972 million in 2004, $1,044 million in 2005, and $1,118 million in 2006.

B. Repeal Special Rules Applicable to FCC-Certified Sales of Broadcast Properties (sec. 2 of H.R. 831 and sec. 1071 of the Code)

Present and Prior Law

Tax treatment of a seller of broadcast property

General tax rules

Under present law, the seller of a business, including a broadcast business, recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is then subject to the current income tax unless the gain is deferred or not recognized under a special tax provision.

Special rules under Code section 1033

Under Code section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion.

Only involuntary conversions that result from destruction, theft, seizure, or condemnation (or threat or imminence thereof) are eligible for deferral under Code section 1033. In addition, the term "condemnation" refers to the process by which private property is taken for public use without the consent of the property owner but upon the award and payment of just compensation, according to a ruling by the Internal Revenue Service (IRS).[4] Thus, for example, an order by a Federal court to a corporation to divest itself of ownership of certain stock because of antitrust rules is not a condemnation (or a threat or imminence thereof), and the divestiture is not eligible for deferral under this provision.[5] Under another IRS ruling, the "threat or imminence of condemnation" test is satisfied if, prior to the execution of a binding contract to sell the property, "the property owner is informed, either orally or in writing by a representative of a governmental body or public official authorized to acquire property for public use, that such body or official has decided to acquire his property, and from the information conveyed to him has reasonable grounds to believe that his property will be condemned if a voluntary sale is not arranged."[6] However, under

[4] Rev. Rul. 58-11, 1958-1 C.B. 273.
[5] *Id.*
[6] Rev. Rul. 74-8, 1974-1 C.B. 200.

this ruling, the threatened taking also must constitute a condemnation, as defined above.

Special rules under Code section 1071

Under prior-law Code section 1071, if the FCC certified that a sale or exchange of property was necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the FCC with respect to the ownership and control of "radio broadcasting stations," a taxpayer was permitted to elect to treat the sale or exchange as an involuntary conversion. The FCC was not required to determine the tax consequences of certifying a sale or to consult with the IRS about the certification process.

Under Code section 1071, the replacement requirement in the case of FCC-certified sales could be satisfied by purchasing stock of a corporation that owned broadcasting property, whether or not the stock represented control of the corporation. In addition, even if the taxpayer did not reinvest all the sales proceeds in similar or related replacement property, the taxpayer nonetheless could elect to defer recognition of gain if the basis of depreciable property that was owned by the taxpayer immediately after the sale or that was acquired during the same taxable year was reduced by the amount of deferred gain.

Tax treatment of a buyer of broadcast property

Under present law, the purchaser of a broadcast business, or any other business, acquires a basis equal to the purchase price paid. In an asset acquisition, a buyer must allocate the purchase price among the purchased assets to determine the buyer's basis in these assets. In a stock acquisition, the buyer generally takes a basis in the stock equal to the purchase price paid, and the business retains its basis in the assets. This treatment applied whether or not the seller of the broadcast property received an FCC certificate exempting the sale transaction from the normal tax treatment.

FCC tax certificate program

Multiple ownership policy

The FCC originally adopted multiple ownership rules in the early 1940s.[7] These rules prohibited broadcast station owners from owning more than one station in the same service area, and, generally, more than six high frequency (radio) or three television stations. Owners wishing to acquire additional stations had to divest themselves of stations they already owned in order to remain in compliance with the FCC's rules.

In November 1943, the FCC adopted a rule that prohibited duopolies (ownership of more than one station in the same city).[8] After these rules were adopted, owners wishing to acquire additional stations in excess of the national ownership limit had to divest themselves of stations they already owned in order to remain in compliance with the FCC's rules. After Code section 1071 was adopted in 1943, in some cases, parties petitioned the FCC for tax

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[7] 5 Fed. Reg. 2382 (June 26, 1940) (multiple ownership rules for high frequency broadcast stations); 5 Fed. Reg. 2284 (May 6, 1941) (multiple ownership rules for television stations).
[8] 8 Fed. Reg. 16065 (Nov. 23, 1943).

certificates pursuant to Code section 1071 when divesting themselves of stations. These divestitures were labeled "voluntary divestitures" by the FCC. When the duopoly rule was adopted, 35 licensees that held more than one license in a particular city were required by the rule "involuntarily" to divest themselves of one of the licenses.[9]

Minority ownership policy

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities (either in the form of assets or stock) to minority individuals or minority-controlled entities.[10] The FCC's policy was based on the view that minority ownership of broadcast stations would provide a significant means of fostering the inclusion of minority views in programming, thereby serving the needs and interests of the minority community as well as enriching and educating the non-minority audience. The FCC subsequently expanded its policy to include the sale of cable television systems to minorities as well.[11]

"Minorities," within the meaning of the FCC's policy, included "Blacks, Hispanics, American Indians, Alaska Natives, Asians, and Pacific Islanders."[12] As a general rule, a minority-controlled corporation was one in which more than 50 percent of the voting stock was held by minorities. A minority-controlled limited partnership was one in which the general partner was a minority or minority-controlled, and minorities had at least a 20-percent interest in the partnership.[13] The FCC required those who acquired broadcast properties with the help of the FCC tax certificate policy to hold those properties for at least one year.[14] An acquisition qualified even if there was a pre-existing agreement (or option) to buy out the minority interests at the end of the one-year holding period, providing that the transaction was at arm's-length.

In 1982, the FCC further expanded its tax certificate policy for minority ownership. At that time, the FCC decided that, in addition to those who sell properties to minorities, investors who contributed to the stabilization of the capital base of a minority enterprise would be entitled to a tax certificate upon the subsequent sale of their interest in the minority entity.[15] To qualify for an FCC tax certificate in this circumstance, an investor must have either (1) provided start-up financing that allows a minority to acquire either broadcast or cable properties, or (2) purchased shares in a minority-controlled entity within the first year after the license necessary to operate the property was issued to the minority. An investor could qualify for a tax certificate even if the sale of the interest oc-

[9] FCC Announces New Policy Relating to Issuance of Tax Certificates, 14 FCC 2d 827 (1956).
[10] Minority Ownership of Broadcasting Facilities, 68 FCC2d 979 (1978).
[11] Minority Ownership of Cable Television Systems, 52 R.R.2d 1469 (1982).
[12] 52 R.R.2d at n. 1.
[13] Commission's Policy Regarding the Advancement of Minority Ownership in Broadcasting, Policy Statement, and Notice of Proposed Rulemaking, 92 FCC2d 853-855 (1982).
[14] See Amendment of Section 73.3597 of the Commission's Rules (Applications for Voluntary Assignments or Transfers of Control), 57 R.R.2d 1149 (1985). Anti-trafficking rules require cable properties to be held for at least three years (unless the property is sold pursuant to a tax certificate).
[15] Commission Policy Regarding the Advancement of Minority Ownership in Broadcasting, 92 FCC2d 849 (1982).

curred after participation by a minority in the entity had ceased. In these situations, the status of the divesting investor and the purchaser of the divested interest was irrelevant, because the goal was to increase the financing opportunities available to minorities.

Personal communications services ownership policy

In 1993, Congress provided for the orderly transfer of frequencies, including frequencies that can be licensed pursuant to competitive bidding procedures.[16] The FCC adopted rules to conduct auctions for the award of more than 2,000 licenses to provide personal communications services ("PCS"). PCS are provided by means of a new generation of communication devices that will include small, lightweight, multi-function portable phones, portable facsimile and other imaging devices, new types of multi-channel cordless phones, and advanced paging devices with two-way data capabilities.

The FCC designed procedures to ensure that small businesses, rural telephone companies and businesses owned by women and minorities have "the opportunity to participate in the provision" of PCS, as Congress directed in 1993.[17] To help minorities and women participate in the auction of the PCS licenses, the FCC took several steps including up to a 25-percent bidding credit, a reduced upfront payment requirement, a flexible installment payment schedule, and an extension of the tax certificate program for businesses owned by minorities and women.[18]

The FCC intended to employ the tax certificate program in three ways: (1) initial investors (who provide "start-up" financing or purchase interests within the first year after license issuance) in minority and woman-owned PCS businesses would have been eligible for FCC tax certificates upon the sale of their investments; (2) holders of PCS licenses would have been able to obtain FCC tax certificates upon the sale of the business to a company controlled by minorities and women; and (3) a cellular operator that sells its interest in an overlapping cellular system to a minority or a woman-owned business to come into compliance with the FCC PCS/cellular cross-ownership rule would have been eligible for a tax certificate. In addition, as discussed below, the FCC would have issued tax certificates for PCS to encourage fixed microwave operators voluntarily to relocate to clear a portion of the spectrum for PCS technologies.

Microwave relocation policy

PCS can operate only on frequencies below 3GHz. However, because that frequency range is currently occupied by various private fixed microwave communications systems (such as railroads, oil pipelines, and electric utilities), there are no large blocks of unallocated spectrum available to PCS. To accommodate PCS, the FCC has reallocated the spectrum; the 1850-1990MHz spectrum will be used for PCS, and the microwave systems will be required to move to higher frequencies. Current occupants of the 1850-1990MHz spectrum allocated to PCS must relocate to higher fre-

[16] Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66, Title VI).
[17] Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66, sec. 6002(a)).
[18] Installment payments are available to small businesses and rural telephone companies.

quencies not later than three years after the close of the bidding process.[19] In accordance with FCC rules, these current occupants have the right to be compensated for the cost of replacing their old equipment, which can operate only on the 1850-1990MHz spectrum, with equipment that will operate at the new, higher frequency. At a minimum, the winners of the new PCS licenses must pay for and install new facilities to enable the incumbent microwave operators to relocate. The amount of these payments and characteristics of the new equipment will be the subject of negotiation between the incumbent microwave operators and the PCS licensees; thus, the nature of the compensation (i.e., solely replacement equipment, or a combination of replacement equipment plus a cash payment) is unknown at present. If no agreement is reached within the 3-year voluntary negotiation period, the microwave operators will be required by the FCC to vacate the spectrum; however, the timing of such relocation is uncertain because the relocation would take place only after completion of a formal negotiation process in which the FCC would be a participant.

The FCC would have employed the tax certificate program for PCS to encourage fixed microwave operators voluntarily to relocate from the 1850-1990MHz band to clear the band for PCS technologies.[20] Tax certificates would have been available to incumbent microwave operators that relocate voluntarily within three years following the close of the bidding process. Thus, the certificates were intended to encourage such occupants to relocate more quickly than they otherwise would and to clarify the tax treatment of such transactions.[21]

Congressional appropriations rider

Since fiscal year 1988, in appropriations legislation, the Congress prohibited the FCC from using any of its appropriated funds to repeal, to retroactively apply changes in, or to continue a reexamination of its comparative licensing, distress sale and tax certificate policies.[22] This limitation did not prevent an expansion of the existing program.[23] The last rider expired at the end of the 1995 fiscal year, September 30, 1995.

Reasons for Change

The Congress, in its review of the administration and operation of Code section 1071, found serious tax policy problems with this provision. As an initial matter, the standards pursuant to which the FCC would issue tax certificates evolved far beyond what Congress originally contemplated. Congress originally intended Code section 1071 to alleviate the burden of taxpayers who were forced

[19] The PCS auctions for the 1850-1990MHz spectrum commenced in December, 1994.
[20] See, Third Report and Order and Memorandum Opinion and Order, 8 FCC Rcd 6589 (1993).
[21] The transaction between the PCS licensee and the incumbent microwave operator might qualify for tax-free treatment as a like-kind exchange under Code section 1031 or as an involuntary conversion under Code section 1033. However, the availability of deferral under these Code provisions may be uncertain in certain circumstances. For example, it may be unclear whether the transaction would qualify as an involuntary conversion under currently applicable IRS standards.
[22] Public Law 100-202 (1987).
[23] The appropriations restriction "does not prohibit the agency from taking steps to create greater opportunity for minority ownership." H. Rept. 103-708 (Conf. Rept.), 103d Cong. 2d Sess. 40 (1994).

to sell their radio stations under difficult wartime circumstances. The FCC interpreted the provision to permit the FCC to grant unlimited tax benefits for routine and voluntary sales of a wide range of communication properties.

In addition, the FCC's standards for issuing tax certificates were so vague that the program appears to have been subject to significant abuse. For example, the FCC's definition of "control" for purposes of its minority ownership policies provided little guarantee that a minority would effectively manage a broadcast property after the sale of property has been certified. In addition, because the FCC generally required only one year of minority ownership or control to qualify for a tax certificate, section 1071 frequently resulted in only transitory minority ownership of broadcast properties, i.e., in many cases the granting of the tax certificate did not result in achieving the objective of minority ownership or control.

Further, the FCC's interpretation and administration of the tax certificate program was not supervised or subject to any systematic review by the IRS, or any other government body that could evaluate the tax cost of the program. In granting tax certificates, the FCC did not take into account or request any information regarding the size of the potential tax benefit involved. The FCC also did not request any showing or representation that the amount of the tax benefits, which at least initially accrued to the non-minority seller generally, was in any way reflected in the form of a lower purchase price to the minority-owned or controlled purchaser. As a result, it was possible that, in many cases, the entire tax benefit accrued to the non-minority seller.

From a tax policy perspective, the Congress found serious deficiencies in section 1071. No other provision of the Internal Revenue Code conveyed the level of discretion to a Federal government agency comparable to the discretion conveyed on the FCC by section 1071. Thus, section 1071 granted the authority to the FCC to administer what was, in effect, an open-ended entitlement program with no constraints imposed to limit the extent to which the FCC utilized the provision.

As a result of these considerations, the Congress concluded that the tax cost of the FCC tax certificate program far outweighed any demonstrated benefit of the program. The Congress also concluded that the section was inconsistent with sound tax policy. The Congress therefore repealed the provision.

Explanation of Provision

H.R. 831 repeals Code section 1071. Thus, a sale or exchange of broadcast properties is subject to the same tax rules applicable to all other taxpayers engaged in the sale or exchange of a business.

Effective Date

The repeal of section 1071 is effective for (1) sales or exchanges on or after January 17, 1995, and (2) sales or exchanges before that date if the FCC tax certificate with respect to the sale or exchange is issued on or after that date. The provision does not apply to taxpayers who entered into a binding written contract (or have completed a sale or exchange pursuant to a binding written contract)

before January 17, 1995, and who applied for an FCC tax certificate by that date. A contract is treated as not binding for this purpose if the sale or exchange pursuant to the contract (or the material terms of the contract) was contingent on January 16, 1995, on issuance of an FCC tax certificate. A sale or exchange was not contingent on January 16, 1995, on issuance of an FCC tax certificate if the tax certificate had been issued by the FCC by that date. The material terms of an otherwise binding contract in effect on January 16, 1995, was not treated as contingent on the issuance of an FCC tax certificate solely because the contract provided that the sales price was increased by an amount not greater than 10 percent of the sales price in the event an FCC tax certificate was not issued.

Revenue Effect

The provision is estimated to increase fiscal year Federal budget receipts by $303 million in 1995, $379 million in 1996, $135 million in 1997, $135 million in 1998, $170 million in 1999, $201 million in 2000, $232 million in 2001, $263 million in 2002, $293 million in 2003, $322 million in 2004, $355 million in 2005, and $355 million in 2006.

C. Prohibit Nonrecognition of Gain on Involuntary Conversions in Certain Related-Party Transactions; Application of Section 1033 to Certain Microwave Relocation Transactions (sec. 3 of H.R. 831 and sec. 1033 of the Code)

Present and Prior Law

Under present law, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period (sec. 1033).

Under rulings issued by the IRS to taxpayers, property (stock or assets) purchased from a related person could, in some cases, qualify as property similar or related in service or use to the converted property.[24] Thus, in certain circumstances, related taxpayers could obtain significant (and possibly indefinite or permanent) tax deferral without any additional cash outlay to acquire new properties. In cases in which a taxpayer purchased stock as replacement property, section 1033 permitted the taxpayer to reduce basis of stock, but did not require any reduction in the basis of the underlying assets.[25] Thus, the reduction in basis of stock did not result in reduced depreciation deductions.

Reasons for Change

In the course of its deliberations on the repeal of section 1071, the Congress also became aware of problems with the operation of

[24] See, e.g., PLR 8132072 and PLR 8020069. Private letter rulings do not have precedential authority and may not be relied upon by any taxpayer other than the taxpayer receiving the ruling but are some indication of IRS administrative practice.

[25] Section 1610 of H.R. 3448 (the "Small Business Job Protection Act of 1996"), as passed by the Congress and signed by the President, requires the basis of property held by a corporation to be adjusted when stock of the corporation is acquired as replacement property under section 1033. (See the discussion in Part Four of this pamphlet.)

section 1033. Under interpretations issued by the IRS, taxpayers were able to purchase replacement property from a related party, thereby avoiding the need to buy "new" replacement property and, sometimes, effectively resulting in a total tax forgiveness for the transaction. The Congress intended that, in the future, corporate taxpayers be required to buy replacement property only from unrelated persons in order to receive the special tax treatment under section 1033.

In addition, the Congress sought to ensure tax-free treatment for transactions between PCS licensees and the incumbent microwave operators in connection with the relocation of the microwave operators from the 1850-1990MHz spectrum by reason of the FCC's reallocation of that spectrum for use for PCS. Thus, the Congress intended that such transactions constitute involuntary conversions under Code section 1033. However, no inference was intended with respect to the nature or appropriate tax treatment of any other transactions.

Explanation of Provision

Related-party transactions

Under H.R. 831, a subchapter C corporation is not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to the general rule provides that a C corporation could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the period prescribed under section 1033. Thus, property acquired from outside the group of related persons within the period prescribed by section 1033 and retransferred to the taxpayer member of the group within the prescribed time period, will qualify in the hands of the taxpayer to the extent that the property's basis or other net tax consequences to the group do not change as a result of the transfer.

The provision also applies to a partnership if more than 50 percent of the capital interest, or profits interest, of the partnership are owned, directly or indirectly (as determined under section 707(b)(3)), by one or more C corporations at the time of the involuntary conversion. If the provision applies to a partnership, the provision would apply to all partners of the partnership, including partners that are not C corporations. If the provision does not apply to a partnership, none of the partners of the partnership will be subject to the provision by reason of their interests in the partnership.

The determination of whether or not a partnership is related to another party will be made at the partnership level.

Microwave relocation transactions

H.R. 831 provides that sales or exchanges that are certified by the FCC as having been made by a taxpayer in connection with the relocation of the taxpayer from the 1850-1990MHz spectrum by

reason of the FCC's reallocation of that spectrum for use for PCS will be treated as involuntary conversions to which section 1033 applies. H.R. 831 provides that the FCC shall transmit copies of certificates with respect to these relocations to the Secretary of the Treasury. It was intended that the FCC supply the Secretary of the Treasury such information with respect to microwave relocations as is necessary for the Secretary to be informed of the tax ramifications of these transactions.

Effective Date

The provision prohibiting the purchase of qualified replacement property from a related party applies to involuntary conversions occurring on or after February 6, 1995.

The provision treating certain microwave relocation transactions as involuntary conversions applies to sales or exchanges occurring before January 1, 2000.

Revenue Effect

The provision is estimated to increase fiscal year Federal budget receipts by $5 million in 1995, $9 million in 1996, $23 million in 1997, $33 million in 1998, $47 million in 1999, $67 million in 2000, $87 million in 2001, $111 million in 2002, $137 million in 2003, $165 million in 2004, $189 million in 2005, and $202 million in 2006.

D. Unearned Income Test for Earned Income Credit (sec. 4 of H.R. 831 and sec. 32 of the Code)

Present and Prior Law

Eligible low-income workers are able to claim a refundable earned income credit (EIC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or adjusted gross income, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or adjusted gross income, if greater) exceeds the phaseout limit. There is no additional limitation on the amount of unearned income that the taxpayer may receive.

The credit rates and phaseout rates for the EIC change over time under present law. For 1996 and after, the credit rate is 40 percent and the phaseout rate is 21.06 percent for taxpayers with two or more qualifying children. The credit rate for taxpayers with one qualifying child or no qualifying children for 1996 is 34 percent and 7.65 percent, respectively. The phaseout rate for taxpayers with one qualifying child and no qualifying children for 1996 is 15.98 percent and 7.65 percent, respectively.

The earned income threshold and the phaseout threshold are indexed for inflation; because the phaseout limit depends on those amounts, the phaseout rate, and the credit rate, the phaseout limit will also increase if there is inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

In order to claim the EIC, a taxpayer must either have a qualifying child or must meet other requirements. A qualifying child must meet a relationship test, an age test, and a residence test. In order to claim the EIC without a qualifying child, a taxpayer must not be a dependent and must be over age 24 and under age 65.

Reasons for Change

Under prior law, a taxpayer could have had relatively low earned income, and therefore could have been eligible for the EIC, despite also having significant unearned income. The Congress believed that the EIC should be targeted to families with the greatest need. Therefore, the Congress believed that it was inappropriate to allow an EIC to taxpayers with significant unearned income.

Explanation of Provision[26]

H.R. 831 provided that a taxpayer was not eligible for the EIC if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeded $2,350. Disqualified income was the sum of:

(1) interest and dividends includible in gross income for the taxable year;

(2) tax-exempt interest received or accrued in the taxable year; and

(3) net income (if greater than zero) from rents and royalties not derived in the ordinary course of business.

Under H.R. 831, tax-exempt interest was defined as amounts required to be reported on the taxpayer's return under Code section 6012(d).

Effective Date

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

Revenue Effect

The provision was estimated to increase Federal fiscal year budget receipts by $22 million in 1996, $436 million in 1997, $487 million in 1998, $521 million in 1999, $556 million in 2000, $612 million in 2001, $655 million in 2002, $700 million in 2003, $748 million in 2004, $800 million in 2005, and $852 million in 2006.

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[26] The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193, August 22, 1996) also modified the operation of the earned income credit. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 specifically amended the operation of the unearned income test. (See the discussion in Part Six of this pamphlet.)

E. Extension of Rule for Certain Group Health Plans (sec. 5 of H.R. 831 and sec. 162(n) of the Code)

Prior Law

In general, prior law disallowed employer deductions for any amounts paid or incurred in connection with a group health plan if the plan fails to reimburse hospitals for inpatient services provided in the State of New York at the same rate that licensed commercial insurers are required to reimburse hospitals for inpatient services of individuals not covered by a group health plan. This provision applied with respect to inpatient hospital services provided to participants after February 2, 1993, and on or before May 12, 1995.

Reasons for Change

The Congress found it appropriate to extend the prior-law deduction disallowance for expenses in connection with certain group health plans for a temporary period.

Explanation of Provision

H.R. 831 extended the prior-law deduction disallowance for expenses in connection with certain group health plans through December 31, 1995.

Effective Date

The provision was effective on the date of enactment.

Revenue Effect

The provision was estimated to reduce Federal fiscal year budget receipts by $42 million in 1995 and $11 million in 1996.

PART TWO:

TAX BENEFITS FOR INDIVIDUALS PERFORMING SERVICES IN CERTAIN HAZARDOUS DUTY AREAS (H.R. 2778)[27]

Present and Prior Law

General time limits for filing tax returns

Present law provides that individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year (sec. 6072). Present law also provides that the Secretary may grant reasonable extensions of time for filing such returns (sec. 6081). Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty outside the United States (Treas. Reg. sec. 1.6081-5(a)(6)). No action is necessary to apply for this extension. This extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual properly filing that form (Treas. Reg. sec. 1.6081-4T).

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, present law suspends the period of time for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities (sec. 7508). An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President also designates the period of

[27] Public Law 104-117; signed on March 20, 1996.
H.R. 2778 was reported by the House Committee on Ways and Means on February 29, 1996 (H. Rept. 104-465), and was passed by the House on March 5, 1996. The bill was passed by the Senate on March 6, 1996.

combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone. In addition, it encompasses any time of continuous hospitalization resulting from injury received in the combat zone[28] or time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts: (1) Filing any return of income, estate, or gift tax (except employment and withholding taxes); (2) Payment of any income, estate, or gift tax (except employment and withholding taxes); (3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court; (4) Allowance of a credit or refund of any tax; (5) Filing a claim for credit or refund of any tax; (6) Bringing suit upon any such claim for credit or refund; (7) Assessment of any tax; (8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax; (9) Collection of the amount of any liability in respect of any tax; (10) Bringing suit by the United States in respect of any liability in respect of any tax; and (11) Any other act required or permitted under the internal revenue laws specified in regulations prescribed under section 7508 by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension.

Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any part of any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding does not apply to military pay for any month in which an employee (whether enlisted personnel or commissioned officer) is entitled to the exclusion from income for combat pay (sec. 3401(a)(1)).

[28] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitalization inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

Exemption from tax upon death in a combat zone

An individual in active service as a member of the Armed Forces who dies while serving in a combat zone (or as a result of wounds, disease, or injury received while serving in a combat zone) is not subject to income tax for the year of death (as well as for any prior taxable year ending on or after the first day the individual served in the combat zone) (sec. 692). Special computational rules apply in the case of joint returns. A reduction in estate taxes is also provided with respect to individuals dying under these circumstances (sec. 2201).

Special rules permit the filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)). Special rules for determining surviving spouse status apply where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3)).

Exemption from telephone excise tax

The telephone excise tax is not imposed on "any toll telephone service" that originates in a combat zone (sec. 4253(d)).

Operation Desert Storm: Executive Order designating Persian Gulf Area as a combat zone

On January 21, 1991, President Bush signed Executive Order 12744, designating the Persian Gulf Area as a combat zone. This designation was retroactive to January 17, 1991, the date combat commenced in that area, and continues in effect until terminated by another Executive Order. An Executive Order terminating this combat zone designation has not been issued. Thus, individuals serving in the Persian Gulf Area are eligible for the suspension of time provisions and military pay exclusions (among other provisions) described above, beginning on January 17, 1991.

The Executive Order specifies that the Persian Gulf Area is the Persian Gulf, the Red Sea, the Gulf of Oman, part of the Arabian Sea, the Gulf of Aden, and the entire land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

The Department of Defense provides to the Internal Revenue Service, on a monthly basis, a computer tape with information regarding the military personnel whose service is in the combat zone designated by the Executive Order and who are therefore eligible for, among other provisions, the extension of time provisions of section 7508 and the exclusion from income provisions of section 112.

Operation Desert Shield: Legislative extension of time

On January 30, 1991, President Bush signed Public Law 102-2. This Act amended section 7508 by providing that any individual who performs Desert Shield services (and the spouse of such an individual) is entitled to the benefits of the suspension of time provisions of section 7508. Desert Shield services are defined as services in the Armed Forces of the United States (or in support of those Armed Forces) if such services are performed in the area designated by the President as the "Persian Gulf Desert Shield area" and such services are performed during the period beginning August 2, 1990, and ending on the date on which any portion of the

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area was designated by the President as a combat zone pursuant to section 112 (which was January 17, 1991).

Operation Joint Endeavor: Administrative extension of time

On December 12, 1995, the Internal Revenue Service announced[29] that it was administratively extending the time to file tax returns until December 15, 1996, for members of the Armed Forces "departing 'Operation Joint Endeavor'" on or after March 1, 1996. In addition, the IRS stated that the penalties for failure to file tax returns and failure to pay taxes would not be assessed with respect to these individuals. Also, the IRS stated that it would administratively place any balance due accounts into suspense status and suspend examinations while the member is serving in "Operation Joint Endeavor."

IRS user fees

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. The Uruguay Round Agreements Act extended the IRS user fee program for five years (until October 1, 2000).

Reasons for Change

The Congress believed that it was appropriate to apply the special tax rules applicable to combat zones to service in Bosnia and Herzegovina, Croatia, and Macedonia in the same manner as if they were a combat zone.

Explanation of Provisions

Treatment of portions of former Yugoslavia as if they were a combat zone

H.R. 2778 provides that a qualified hazardous duty area shall be treated in the same manner as if it were a combat zone for purposes of the following provisions of the Code: (1) the special rule for determining surviving spouse status where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3)); (2) the exclusions from income for combat pay (sec. 112); (3) forgiveness of income taxes of members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 692); (4) the reduction in estate taxes for members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 2201); (5) the exemption from income tax withholding for military pay for any month in which an employee is entitled to the exclusion from income (sec. 3401(a)(1)); (6) the exemption from the telephone excise tax for toll telephone service that originates in a combat zone (sec. 4253(d)); (7) the special rule permitting filing of a joint return where a spouse is in missing

[29] Letter from John T. Lyons, Assistant Commissioner (International), Internal Revenue Service, to Lt. Col. David M. Pronchick, Armed Forces Tax Counsel, Department of Defense.

status as a result of service in a combat zone (sec. 6013(f)(1)); and (8) the suspension of time provisions (sec. 7508).

A qualified hazardous duty area means Bosnia and Herzegovina, Croatia, or Macedonia, if, as of the date of enactment, any member of the Armed Forces is entitled to hostile fire/imminent danger pay for services performed in such country. Members of the Armed Forces are in Bosnia and Herzegovina and Croatia as part of "Operation Joint Endeavor" (the NATO operation). Members of the Armed Forces are in Macedonia as part of "Operation Able Sentry" (the United Nations operation).

Suspension of time provisions for other Operation Joint Endeavor personnel

An individual who is performing services as part of Operation Joint Endeavor outside the United States while deployed away from the individual's permanent duty station will qualify for the suspension of time provisions in section 7508 of the Code during the period that hostile fire/imminent danger pay is paid in Bosnia and Herzegovina, Croatia, or Macedonia.

Combat pay exclusion for officers

In addition, H.R. 2778 raises the dollar value of the exclusion from income for any combat pay for officers in section 112 of the Code from the present-law level of $500 per month to the highest rate of basic pay at the highest pay grade that enlisted personnel may receive plus the amount of hostile fire/imminent danger pay which the officer receives. As of the date of enactment, the highest level of basic pay received by enlisted members of the Armed Forces was $4,104.80 per month. P.L. 104-117 also conforms the wage withholding rules to the income exclusion rules for officers.

Extension of IRS user fees

H.R. 2778 extends IRS user fees for three additional years (until October 1, 2003).

Effective Date

The provision generally is effective on November 21, 1995 (the date on which the Dayton Accord was initialed); the modifications to the wage withholding rules apply to remuneration paid after the date of enactment (March 20, 1996). The provision relating to IRS user fees is effective on the date of enactment (March 20, 1996).

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $38 million in 1996 and $45 million in 1997 and to increase Federal fiscal year budget receipts by $35 million annually in 2001, 2002, and 2003.

PART THREE:

TAXPAYER BILL OF RIGHTS 2 (H.R. 2337) [30]

A. Taxpayer Bill of Rights 2 Provisions

1. Taxpayer advocate

a. Establishment of position of Taxpayer Advocate within Internal Revenue Service (sec. 101 of TBOR 2 and sec. 7802 of the Code)

Prior Law

The Office of the Taxpayer Ombudsman was created by the Internal Revenue Service (IRS) in 1979. The Taxpayer Ombudsman's duties are to serve as the primary advocate, within the IRS, for taxpayers. As the taxpayers' advocate, the Taxpayer Ombudsman participates in an ongoing review of IRS policies and procedures to determine their impact on taxpayers, receives ideas from the public concerning tax administration, identifies areas of the tax law that confuse or create an inequity for taxpayers, and supervises cases handled under the Problem Resolution Program. Under prior procedures, the Taxpayer Ombudsman is selected by the Commissioner of the IRS and serves at the Commissioner's discretion.

Reasons for Change

To date, the Taxpayer Ombudsman has been a career civil servant selected by and serving at the pleasure of the IRS Commissioner. Some may perceive that the Taxpayer Ombudsman is not an independent advocate for taxpayers. In order to ensure that the Taxpayer Ombudsman has the necessary stature within the IRS to represent fully the interests of taxpayers, Congress believed it appropriate to elevate the position to a position comparable to that of the Chief Counsel. In addition, in order to ensure that the Congress is systematically made aware of recurring and unresolved problems and difficulties taxpayers encounter in dealing with the IRS, the Taxpayer Ombudsman should have the authority and responsibility to make independent reports to the Congress in order to advise the tax-writing committees of those areas.

Explanation of Provision

TBOR 2 establishes a new position, Taxpayer Advocate, within the IRS. This replaces the position of Taxpayer Ombudsman. The Taxpayer Advocate is appointed by and reports directly to the Com-

[30] Public Law 104-168; signed on July 30, 1996; hereinafter referred to as "TBOR 2".
H.R. 2337 was reported by the House Committee on Ways and Means on March 28, 1996 (H. Rept. 104-506), and was passed by the House on April 16, 1996. The bill was passed by the Senate on July 11, 1996.

missioner. Compensation of the Taxpayer Advocate is at a level equal to that of the highest level official reporting directly to the Deputy Commissioner of the IRS.

TBOR 2 also establishes the Office of Taxpayer Advocate within the IRS. The functions of the office are (1) to assist taxpayers in resolving problems with the IRS, (2) to identify areas in which taxpayers have problems in dealings with the IRS, (3) to propose changes (to the extent possible) in the administrative practices of the IRS that will mitigate those problems, and (4) to identify potential legislative changes that may mitigate those problems.

While the Taxpayer Advocate would not have direct line authority over the regional and local Problem Resolution Officers (PROs), the Congress believes that all PROs should take direction from the Taxpayer Advocate and that they should operate with sufficient independence to assure that taxpayer rights are not being subordinated to pressure from local revenue officers, district directors, etc. Accordingly, the Congress recommends and encourages that regional PROs actively participate in the selection and evaluation of local PROs.

The Taxpayer Advocate is required to make two annual reports to the tax-writing committees. The first report is to contain the objectives of the Taxpayer Advocate for the next calendar year. This report is to contain full and substantive analysis, in addition to statistical information, and is due not later than June 30 of each year.

The second report is on the activities of the Taxpayer Advocate during the previous fiscal year. The report must identify the initiatives the Taxpayer Advocate has taken to improve taxpayer services and IRS responsiveness, contain recommendations received from individuals who have the authority to issue a Taxpayer Assistance Order (TAO), describe in detail the progress made in implementing these recommendations, contain a summary of at least 20 of the most serious problems which taxpayers have in dealing with the IRS, include recommendations for such administrative and legislative action as may be appropriate to resolve such problems, describe the extent to which regional problem resolution officers participate in the selection and evaluation of local problem resolution officers, and include other such information as the Taxpayer Advocate may deem advisable. The Commissioner is required to establish internal procedures that will ensure a formal IRS response within three months to all recommendations submitted to the Commissioner by the Taxpayer Advocate. This second report is due not later than December 31 of each year.

The reports submitted to Congress by the Taxpayer Advocate are not subject to prior review by the Commissioner, the Secretary of the Treasury, any other officer or employee of the Department of the Treasury, or the Office of Management and Budget. The objective is for Congress to receive an unfiltered and candid report of the problems taxpayers are experiencing and what can be done to address them. The reports by the Taxpayer Advocate are not official legislative recommendations of the Administration; providing official legislative recommendations remains the responsibility of the Department of Treasury.

Effective Date

The provision is effective on the date of enactment. The first annual reports of the Taxpayer Advocate are due in June and December 1996.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Expansion of authority to issue Taxpayer Assistance Orders (sec. 102 of TBOR 2 and sec. 7811 of the Code)

Prior Law

Code section 7811(a) authorizes the Taxpayer Ombudsman to issue a Taxpayer Assistance Order (TAO). TAOs may order the release of taxpayer property levied upon by the IRS and may require the IRS to cease any action, or refrain from taking any action if, in the determination of the Taxpayer Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered.

Reasons for Change

The requirement that the significant hardship be as a result of the manner in which the internal revenue laws are being administered has resulted in confusion as to the circumstances which justify the issuance of a TAO. The most frequent situation where a TAO may be needed, but may not have been authorized under prior law, involves income tax refunds that are needed to relieve severe hardship of taxpayers. Another example involves the re-issuance of refund checks which have been sent by the IRS to an address at which the taxpayer no longer resides. While the mailing of the check to the incorrect address might in no way be due to the fault of the IRS, the normal delays in reissuing such a check may cause great hardship for the taxpayer. Also, the IRS Collection Division may take an enforcement action when the taxpayer has had no actual notice of the deficiency and is not afforded any opportunity to obtain an administrative review of the validity of the tax deficiency. In cases like these, it may be appropriate for the Taxpayer Advocate to issue a TAO to temporarily stay the IRS collection action in order to allow for a review of the appropriateness of the proposed action.

Explanation of Provision

TBOR 2 provides the Taxpayer Advocate with broader authority to affirmatively take any action as permitted by law with respect to taxpayers who would otherwise suffer a significant hardship as a result of the manner in which the IRS is administering the tax laws. In addition, TBOR 2 provides that a TAO may specify a time period within which the TAO must be followed. Further, TBOR 2 provides that only the Taxpayer Advocate, the Commissioner of the IRS, or the Deputy Commissioner, may modify or rescind a TAO. Any official who modifies or rescinds a TAO must provide the Tax-

payer Advocate a written explanation of the reasons for the modification or rescission.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

2. Modifications to installment agreement provisions

a. Notification of reasons for termination of installment agreements (sec. 201 of TBOR 2 and sec. 6159 of the Code)

Present and Prior Law

Section 6159 authorizes the IRS to enter into written installment agreements with taxpayers to facilitate the collection of tax liabilities. In general, the IRS has the right to terminate (or in some instances, alter or modify) such agreements if the taxpayer provided inaccurate or incomplete information before the agreement was entered into, if the taxpayer fails to make a timely payment of an installment or another tax liability, if the taxpayer fails to provide the IRS with a requested update of financial condition, if the IRS determines that the financial condition of the taxpayer has changed significantly, or if the IRS believes collection of the tax liability is in jeopardy. If the IRS determines that the financial condition of a taxpayer that has entered into an installment agreement has changed significantly, the IRS must provide the taxpayer with a written notice that explains the IRS determination at least 30 days before altering, modifying, or terminating the installment agreement. No notice is statutorily required if the installment agreement is altered, modified, or terminated for other reasons.

Reasons for Change

The Congress believed that the IRS generally should notify taxpayers if an installment agreement is altered, modified, or terminated.

Explanation of Provision

TBOR 2 requires the IRS to notify taxpayers 30 days before altering, modifying, or terminating any installment agreement for any reason other than that the collection of tax is determined to be in jeopardy. The IRS must include in the notification an explanation of why the IRS intends to take this action.

Effective Date

The provision is effective six months after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Administrative review of termination of installment agreements (sec. 202 of TBOR 2 and sec. 6159 of the Code)

Present and Prior Law

The IRS is currently testing an appeal process for various collection actions, including installment agreements, that will permit taxpayers to appeal these collection actions to Appeals Division personnel.

Reasons for Change

The Congress believed that taxpayers should be able to obtain an independent administrative review of terminations of installment agreements.

Explanation of Provision

TBOR 2 requires the IRS to establish additional procedures for an independent administrative review of terminations of installment agreements for taxpayers who request a review.

Effective Date

The provision is effective on January 1, 1997.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

3. Abatement of interest and penalties

a. Expansion of authority to abate interest (sec. 301 of TBOR 2 and sec. 6404 of the Code)

Present and Prior Law

Any assessment of interest on any deficiency attributable in whole or in part to any error or delay by an officer or employee of the IRS (acting in his official capacity) in performing a ministerial act may be abated.

Reasons for Change

The Congress believed that it is appropriate to expand the authority to abate interest to include delays caused by managerial acts of the IRS.

Explanation of Provision

TBOR 2 permits the IRS to abate interest with respect to any unreasonable error or delay resulting from managerial acts as well as ministerial acts. This would include extensive delays resulting from managerial acts such as: the loss of records by the IRS, IRS

personnel transfers, extended illnesses, extended personnel training, or extended leave. On the other hand, interest would not be abated for delays resulting from general administrative decisions. For example, the taxpayer could not claim that the IRS's decision on how to organize the processing of tax returns or its delay in implementing an improved computer system resulted in an unreasonable delay in the Service's action on the taxpayer's tax return, and so the interest on any subsequent deficiency should be waived.

Effective Date

The provision applies to interest accruing with respect to deficiencies or payments for taxable years beginning after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

b. Review of IRS failure to abate interest (sec. 302 of TBOR 2 and sec. 6404 of the Code)

Prior Law

Federal courts generally did not have the jurisdiction to review the IRS's failure to abate interest.

Reasons for Change

The Congress believed that it is appropriate for the Tax Court to have jurisdiction to review IRS's failure to abate interest with respect to certain taxpayers.

Explanation of Provision

TBOR 2 grants the Tax Court jurisdiction to determine whether the IRS's failure to abate interest for an eligible taxpayer was an abuse of discretion. The Tax Court may order an abatement of interest. The action must be brought within 180 days after the date of mailing of the Secretary's final determination not to abate interest. An eligible taxpayer must meet the net worth and size requirements imposed with respect to awards of attorney's fees. No inference is intended as to whether under prior law any court has jurisdiction to review IRS's failure to abate interest.

Effective Date

The provision applies to requests for abatement after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

c. Extension of interest-free period for payment of tax after notice and demand (sec. 303 of TBOR 2 and sec. 6601 of the Code)

Present and Prior Law

In general, a taxpayer must pay interest on late payments of tax. An interest-free period of 10 calendar days is provided to taxpayers who pay the tax due within 10 calendar days of notice and demand.

Reasons for Change

The 10-day interest-free period was designed to give taxpayers time to receive the notice and pay the amount due. Because it may be very difficult for some taxpayers to remit payment within the ten-day period, particularly if the mail has delayed delivery of the notice, the IRS must recompute interest and send another notice to taxpayers.

Explanation of Provision

TBOR 2 extends the interest-free period provided to taxpayers for the payment of the tax liability reflected in the notice from 10 calendar days to 10 business days (21 calendar days, provided that the total tax liability shown on the notice of deficiency is less than $100,000).

Effective Date

The provision applies in the case of any notice and demand given after December 31, 1996.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1996, $7 million in 1997, $8 million in years 1998 to 2000, $9 million in years 2001 to 2003, $10 million in years 2004 and 2005, and $11 million in 2006.

d. Abatement of penalty for failure to make required deposits of payroll taxes in certain cases (sec. 304 of TBOR 2 and sec. 6656 of the Code)

Present and Prior Law

If any person who is required to deposit taxes imposed by the Internal Revenue Code with a government depository fails to deposit such taxes on or before the prescribed date, a penalty may be imposed, unless it is shown that such failure is due to reasonable cause and not willful neglect. The penalty contains a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. The amount of the underpayment for this purpose is the excess of the amount of the tax required to be deposited over the amount of the tax, if any, deposited on or before the prescribed date.

Reasons for Change

The Congress believed that it is appropriate to enumerate additional circumstances under which this penalty may be waived or abated.

Explanation of Provision

TBOR 2 provides that the Secretary may waive this penalty with respect to an inadvertent failure to deposit any employment tax if: (a) the depositing entity meets the net worth requirements applicable for awards of attorney's fees; (b) the failure to deposit occurs during the first quarter that the depositing entity was required to deposit any employment tax; and (c) the return for the employment tax was filed on or before the due date.

TBOR 2 also provides that the Secretary may abate any penalty for failure to make deposits for the first time a depositing entity makes a deposit if it inadvertently sends the deposit to the Secretary instead of to the required government depository.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year on-budget receipts by $23 million in 1996, and $1 million in years 1997 to 2006, and to reduce off-budget receipts by $38 million in 1996 and $1 million for years 1997 to 2006.

4. Joint returns

a. Studies of joint and several liability for married persons filing joint tax returns and other joint return-related issues (sec. 401 of TBOR 2)

Present and Prior Law

Spouses who file a joint tax return are each fully responsible for the accuracy of the return and for the full tax liability. This is true even though only one spouse may have earned the wages or income which is shown on the return. This is "joint and several" liability. Spouses who wish to avoid joint liability may file as a "married person filing separately."

Spouses often file a joint tax return but then later are separated or divorced. If the IRS later disputes the accuracy of the joint tax returns, one spouse may be held liable for the entire tax deficiency stemming from erroneous deductions or omitted income attributable to the other spouse. Therefore, the "innocent" spouse may be held liable for the full deficiency in a subsequent audit occurring after the separation or divorce. This has resulted in a serious hardship being imposed on an "innocent spouse" in a number of cases.

In some cases, a couple addresses the responsibility for tax liability as part of their divorce decree. However, these agreements are not binding on the IRS because the IRS was not a party to the divorce proceeding. Thus, if a former spouse violates the tax responsibilities assigned to him or her in a divorce decree, the other spouse may not rely on the decree in dealing with the IRS.

While present law does contain provisions which give relief to certain innocent spouses in these situations, the provisions are narrowly drawn and strictly interpreted. Therefore, many former

spouses are not able to qualify for the protections of the current "innocent spouse" rules.

In 1930, the Supreme Court ruled in *Poe v. Seaborn*, 282 U.S. 101 (1930), that all the earnings of a married couple in community property states were part of the marital property to which each spouse had an equal right. At the time, married couples generally welcomed this decision because it allowed couples in community property states to benefit from income "splitting" between the husband and wife for income tax purposes. Later, the Federal tax law was changed to allow all married taxpayers to "split" their income by means of filing a joint tax return.

While the income-splitting effect of *Poe v. Seaborn* is now moot, the decision continues to affect married couples in community property states, but in an adverse way. For example, there are cases where a divorced spouse owes the IRS a tax liability based on his or her joint return filed during the marital years. When this spouse remarries, the new spouse's income may become subject to levy in order to satisfy the tax deficiency of the prior spouse. In contrast, if the couple did not live in a community property state, the second spouse's wages could not be levied to pay a tax liability arising from this spouse's first marriage.

Reasons for Change

The Congress believed that the traditional standard of joint and several liability for married couples filing a joint tax return should be re-examined.

Explanation of Provision

TBOR 2 directs the Treasury Department and the General Accounting Office (GAO) to conduct separate studies analyzing the following:

(1) The effects of changing the current standard of "joint and several" liability for married couples to a "proportionate" liability standard. That is, each spouse would be liable only for the income tax attributable to the income of each spouse.

(2) The effects of requiring the IRS to be bound by the terms of a divorce decree which addresses the responsibility for the tax liability on prior joint tax returns.

(3) Whether the current "innocent spouse" provisions provide meaningful relief to former spouses.

(4) The effects of overturning the application of *Poe v. Seaborn* for income tax purposes in community property states.

The Treasury Department and the GAO must examine the tax policy implications, the equity implications, and operational changes which would face the IRS if the liability standard were changed. For example, the studies must consider how a system of proportionate liability would change the way the IRS communicates with taxpayers, conducts audits of joint returns, and enforces tax lien and levies against married couples.

Effective Date

The studies are due six months after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Joint return may be made after separate returns without full payment of tax (sec. 402 of TBOR 2 and sec. 6013 of the Code)

Prior Law

Taxpayers who file separate returns and subsequently determine that their tax liability would have been less if they had filed a joint return are precluded by statute from reducing their tax liability by filing jointly if they are unable to pay the entire amount of the joint return liability before the expiration of the three-year period for making the election to file jointly.

Reasons for Change

Not all taxpayers are able to pay the full amount owed on their returns by the filing deadline. In such circumstances, the IRS encourages the taxpayer to pay the tax as soon as possible or enter into an installment agreement. However, taxpayers who file separate returns and subsequently determine that their tax liability would have been less if they had filed a joint return are precluded from reducing their tax liability by filing jointly if they are unable to pay the entire amount of the joint return liability. This rule may be unfair to taxpayers experiencing financial difficulties.

Explanation of Provision

TBOR 2 repeals the requirement of full payment of tax liability as a precondition to switching from married filing separately status to married filing jointly status.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

c. Disclosure of collection activities with respect to joint returns (sec. 403 of TBOR 2 and sec. 6103 of the Code)

Present and Prior Law

The IRS does not routinely disclose collection information to a former spouse that relates to tax liabilities attributable to a joint return that was filed when married.

Reasons for Change

The Congress believed that it is appropriate to require the IRS to discuss with one former spouse the efforts it has made to collect the joint return tax liability from the other spouse.

Explanation of Provision

If a tax deficiency with respect to a joint return is assessed, and the individuals filing the return are no longer married or no longer reside in the same household, TBOR 2 requires the IRS to disclose in writing (in response to a written request by one of the individuals) to that individual whether the IRS has attempted to collect the deficiency from the other individual, the general nature of the collection activities, and the amount (if any) collected.

Such requests must be made in writing. The IRS may develop procedures to address the frequency of such requests in order to prevent taxpayers from abusing this provision by making numerous requests without good cause. For example, one request per quarter would be a reasonable rate unless the taxpayer had good cause to seek more frequent information.

In making these disclosures, the IRS may omit the current home address and business location of the former spouse. This is designed to prevent the disclosure of such personal information to persons who might be hostile towards a former spouse.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

5. Collection activities

a. Modifications to lien and levy provisions

i. Withdrawal of public notice of lien (sec. 501(a) TBOR 2 and sec. 6323 of the Code)

Present and Prior Law

The IRS must file a notice of lien in the public record, in order to protect the priority of a tax lien. A notice of tax lien provides public notice that a taxpayer owes the Government money. The IRS has discretion in filing such a notice, but may withdraw a filed notice only if the notice (and the underlying lien) was erroneously filed or if the underlying lien has been paid, bonded, or become unenforceable.

Reasons for Change

The Congress believed that it is appropriate to give the IRS discretion to withdraw a notice of lien in other situations as well.

Explanation of Provision

TBOR 2 allows the IRS to withdraw a public notice of tax lien prior to payment in full by the indebted taxpayer without prejudice, if the Secretary determines that (1) the filing of the notice was premature or otherwise not in accordance with the administrative procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability with respect to

which the lien was filed, (3) the withdrawal of the lien will facilitate collection of the tax liability, or (4) the withdrawal of the lien would be in the best interests of the taxpayer (as determined by the Taxpayer Advocate) and of the Government. The IRS must also provide a copy of the notice of withdrawal to the taxpayer. TBOR 2 also requires that, at the written request of the taxpayer, the IRS make reasonable efforts to give notice of the withdrawal of a lien to creditors, credit reporting agencies, and financial institutions specified by the taxpayer.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

ii. Return of levied property (sec. 501(b) of TBOR 2 and sec. 6343 of the Code)

Present and Prior Law

The IRS is authorized to levy on the property of a taxpayer as a means of collecting unpaid taxes. The IRS is able to return levied property to a taxpayer only when the taxpayer has fully paid its liability with respect to tax, interest, and penalty for which the property was levied.

Reasons for Change

There are several situations where the IRS is not authorized to return levied-upon amounts, even when it believes doing so would be equitable and in the best interests of the taxpayer and the Government. For example, if the IRS enters into an installment agreement and, in contradiction to the terms of the installment agreement, the IRS levies on the taxpayer's property, the IRS is prohibited from returning the property to the taxpayer. The Congress believed that it is appropriate to give the IRS authority to return levied property in other circumstances as well.

Explanation of Provision

TBOR 2 allows the IRS to return property (including money deposited in the Treasury) that has been levied upon if the Secretary determines that (1) the levy was premature or otherwise not in accordance with the administrative procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability, (3) the return of the property will facilitate collection of the tax liability, or (4) the return of the property would be in the best interests of the taxpayer (as determined by the Taxpayer Advocate) and the Government.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

iii. Modifications in certain levy exemption amounts (sec. 502 of TBOR 2 and sec. 6334 of the Code)

Prior Law

Property exempt from levy includes personal property with a value of up to $1,650 and books and tools of a trade with a value of up to $1,100.

Reasons for Change

The Congress believed that these amounts should be increased and indexed for inflation.

Explanation of Provision

TBOR 2 increases the exemption amount to $2,500 for personal property and increases the exemption amount to $1,250 for books and tools of a trade. These amounts are indexed for inflation commencing January 1, 1997.

Effective Date

The provision is effective with respect to levies issued after December 31, 1996.

Revenue Effect

The provision is estimated to have no revenue effect for 1996, and would reduce the Federal fiscal year budget receipts by less than $1 million per year for 1997 to 2006.

b. Offers-in-compromise (sec. 503 of TBOR 2 and sec. 7122 of the Code)

Present and Prior Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if: the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts over $500 can only be accepted if the reasons for the acceptance are documented in detail and supported by an opinion of the IRS Chief Counsel.

Reasons for Change

The Congress believed that the $500 threshold amount requiring a written opinion from the IRS Chief Counsel slows the approval process for most offers-in-compromise and is unnecessarily low.

Explanation of Provision

TBOR 2 increases from $500 to $50,000 the amount requiring a written opinion from the Office of Chief Counsel. Compromises below the $50,000 threshold must be subject to continuing quality review by the IRS.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

6. Information returns

a. Civil damages for fraudulent filing of information returns (sec. 601 of TBOR 2 and new sec. 7434 of the Code)

Prior Law

Federal law provided no private cause of action to a taxpayer who is injured because a fraudulent information return has been filed with the IRS asserting that payments have been made to the taxpayer.

Reasons for Change

Some taxpayers may suffer significant personal loss and inconvenience as the result of the IRS receiving fraudulent information returns, which have been filed by persons intent on either defrauding the IRS or harassing taxpayers.

Explanation of Provision

TBOR 2 provides that, if any person willfully files a fraudulent information return with respect to payments purported to have been made to another person, the other person may bring a civil action for damages against the person filing that return. A copy of the complaint initiating the action must be provided to the IRS. Recoverable damages are the greater of (1) $5,000 or (2) the amount of actual damages (including the costs of the action) and, in the court's discretion, reasonable attorney's fees. The court must specify in any decision awarding damages the correct amount (if any) that should have been reported on the information return. An action seeking damages under this provision must be brought within six years after the filing of the fraudulent information return, or one year after the fraudulent information return would have been discovered through the exercise of reasonable care, whichever is later.

The Congress did not want to open the door to unwarranted or frivolous actions or abusive litigation practices. The Congress was concerned, for example, about the possibility that an unfounded or frivolous action might be brought under this section by a current or former employee of an employer who is not pleased with one or

more items that his or her current or former employer has included on the employee's Form W-2. Therefore, actions brought under this section will be subject to Rule 11 of the Federal Rules of Civil Procedure, relating to the imposition of sanctions in the case of unfounded or frivolous claims, to the same extent as other civil actions.

Effective Date

The provision applies to fraudulent information returns filed after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Requirement to conduct reasonable investigations of information returns (sec. 602 of TBOR 2 and sec. 6201 of the Code)

Prior Law

Deficiencies determined by the IRS are generally afforded a presumption of correctness.

Reasons for Change

Taxpayers may encounter difficulties when a payor issues an erroneous information return and refuses to correct the information and report the change to the IRS, or when a fraudulent information return is filed.

Explanation of Provision

TBOR 2 provides that, in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return (Form 1099 or Form W-2) filed by a third party and the taxpayer has fully cooperated with the IRS, the Government has the burden of producing reasonable and probative information concerning the deficiency (in addition to the information return itself). Fully cooperating with the IRS includes (but is not limited to) the following: bringing the reasonable dispute over the item of income to the attention of the IRS within a reasonable period of time, and providing (within a reasonable period of time) access to and inspection of all witnesses, information, and documents within the control of the taxpayer (as reasonably requested by the Secretary).

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million in 1996, $6 million in years 1997 to 1999, $7 million in 2000, $8 million in years 2001 to 2004, and $9 million in 2005 and 2006.

7. Awarding of costs and certain fees

a. United States must establish that its position in a proceeding was substantially justified (sec. 701 of TBOR 2 and sec. 7430 of the Code)

Present and Prior Law

Under section 7430, a taxpayer who successfully challenges a determination of deficiency by the IRS may recover attorney's fees and other administrative and litigation costs if the taxpayer qualifies as a "prevailing party." A taxpayer qualifies as a prevailing party if it: (1) establishes that the position of the United States was not substantially justified; (2) substantially prevails with respect to the amount in controversy or with respect to the most significant issue or set of issues presented; and (3) meets certain net worth and (if the taxpayer is a business) size requirements. A taxpayer must exhaust administrative remedies to be eligible to receive an award of attorney's fees.

Reasons for Change

The Congress believed that it is appropriate for the IRS to demonstrate that it was substantially justified in maintaining its position when the taxpayer substantially prevails and that the IRS should be required to follow its published guidance and private guidance provided to taxpayers.

Explanation of Provision

TBOR 2 provides that, once a taxpayer substantially prevails over the IRS in a tax dispute, the IRS has the burden of proof to establish that it was substantially justified in maintaining its position against the taxpayer. This will switch the current procedure which places the burden of proof on the taxpayer to establish that the IRS was not substantially justified in maintaining its position. Therefore, the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof. TBOR 2 also establishes a rebuttable presumption that the position of the United States was not substantially justified if the IRS did not follow in the administrative proceeding (1) its published regulations, revenue rulings, revenue procedures, information releases, notices, or announcements, or (2) a private letter ruling, determination letter, or technical advice memorandum issued to the taxpayer. This provision only applies to the version of IRS guidance that is most current on the date the IRS's position was taken.

Effective Date

The provision is effective for proceedings commenced after the date of enactment.

Revenue Effect

The provision is estimated to reduce the Federal fiscal year budget receipts by $2 million in years 1996 to 1998, and $3 million in years 1999 to 2006.

b. Increased limit on attorney's fees (sec. 702 of TBOR 2 and sec. 7430 of the Code)

Prior Law

Attorney's fees recoverable by prevailing parties as litigation or administrative costs was originally set at $75 per hour.

Reasons for Change

The Congress believed that these amounts should be raised and indexed for inflation.

Explanation of Provision

TBOR 2 raises the statutory rate to $110 per hour, indexed for inflation beginning after 1996.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million per year for 1996 to 2006.

c. Failure to agree to extension not taken into account (sec. 703 of TBOR 2 and sec. 7430 of the Code)

Present and Prior Law

To qualify for an award of attorney's fees, the taxpayer must have exhausted the administrative remedies available within the IRS.

Reasons for Change

The IRS has taken the position in regulations that attorney's fees cannot be awarded if the taxpayer has not agreed to extend the statute of limitations. In *Minahan v. Commissioner*, 88 T.C. 492 (1987), the Tax Court held that regulation invalid insofar as it provides that a taxpayer's refusal to consent to extend the statute of limitations is to be taken into account in determining whether the taxpayer has exhausted administrative remedies available to the taxpayer.

Explanation of Provision

TBOR 2 provides that any failure to agree to an extension of the statute of limitations cannot be taken into account for purposes of determining whether a taxpayer has exhausted the administrative remedies for purposes of determining eligibility for an award of attorney's fees.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

d. Award of litigation costs permitted in declaratory judgment proceedings (sec. 704 of TBOR 2 and sec. 7430 of the Code)

Prior Law

Section 7430(b)(3) denies any reimbursement for attorney's fees in all declaratory judgment actions, except those actions related to the revocation of an organization's qualification under section 501(c)(3) (relating to tax-exempt status).

Reasons for Change

The Congress believed that it was appropriate to treat declaratory judgment proceedings similar to other tax proceedings, with respect to eligibility for attorney's fees.

Explanation of Provision

TBOR 2 eliminates the prior-law restrictions on awarding attorney's fees in all declaratory judgment proceedings.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

8. Modification to recovery of civil damages for unauthorized collection actions

a. Increase in limit on recovery of civil damages for unauthorized collection actions (sec. 801 of TBOR 2 and sec. 7433 of the Code)

Prior Law

A taxpayer may sue the United States for up to $100,000 of damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or the Treasury regulations promulgated thereunder in connection with the collection of Federal tax with respect to the taxpayer.

Reasons for Change

The Congress believed that the cap for damages caused by IRS employees should be raised.

Explanation of Provision

TBOR 2 increases the cap from $100,000 to $1 million.

Effective Date

The provision applies to unauthorized collection actions by IRS employees that occur after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million per year for 1996 to 2006.

b. Court discretion to reduce award for litigation costs for failure to exhaust administrative remedies (sec. 802 of TBOR 2 and sec. 7433 of the Code)

Prior Law

A taxpayer suing the United States for civil damages for unauthorized collection activities must exhaust administrative remedies to be eligible for an award.

Reasons for Change

The Congress believed that there may be circumstances in which it is inappropriate to require a taxpayer to exhaust administrative remedies.

Explanation of Provision

TBOR 2 permits (but does not require) a court to reduce an award if the taxpayer has not exhausted administrative remedies.

Effective Date

The provision is effective for proceedings commenced after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million per year for 1996 to 2006.

9. Modification to penalty for failure to collect and pay over tax

a. Preliminary notice requirement (sec. 901 of TBOR 2 and sec. 6672 of the Code)

Present and Prior Law

Under section 6672, a "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected or paid to the government on a timely basis. An individual the IRS has identified as a responsible person is permitted an administrative appeal on the question of responsibility.

Reasons for Change

Some employees may not be fully aware of their personal liability under section 6672 for the failure to pay over trust fund taxes. The Congress believed that IRS could make additional efforts to assist the public in understanding its responsibilities.

Explanation of Provision

TBOR 2 requires the IRS to issue a notice to an individual the IRS had determined to be a responsible person with respect to unpaid trust fund taxes at least 60 days prior to issuing a notice and demand for the penalty. The statute of limitations shall not expire before the date 90 days after the date on which the notice was mailed. The provision does not apply if the Secretary finds that the collection of the penalty is in jeopardy.

Effective Date

The provision applies to assessments made after June 30, 1996.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Disclosure of certain information where more than one person subject to penalty (sec. 902 of TBOR 2 and sec. 6103 of the Code)

Prior Law

The IRS may not disclose to a responsible person the IRS's efforts to collect unpaid trust fund taxes from other responsible persons, who may also be liable for the same tax liability.

Reasons for Change

The Congress believed that it is appropriate to permit the IRS to disclose to a responsible person whether the IRS is imposing the penalty on any other responsible person, and whether the IRS has been successful in collecting the penalty against such a person.

Explanation of Provision

TBOR 2 requires the IRS, if requested in writing by a person considered by the IRS to be a responsible person, to disclose in writing to that person the name of any other person the IRS has determined to be a responsible person with respect to the tax liability. The IRS is required to disclose in writing whether it has attempted to collect this penalty from other responsible persons, the general nature of those collection activities, and the amount (if any) collected. Failure by the IRS to follow this provision does not absolve any individual for any liability for this penalty.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

c. Right of contribution from multiple responsible parties (sec. 903 of TBOR 2 and sec. 6672 of the Code)

Present and Prior Law

A responsible person may seek to recover part of the amount which he has paid to the IRS from other individuals who also may have the obligations of a responsible person but who have not yet contributed their proportionate share of their liability under section 6672. Taxpayers must pursue such claims for contribution under state law (to the extent state law permits such claims). The variations in state law sometimes make it difficult or impossible to press successful suits in state courts to force a contribution from other responsible persons.

Reasons for Change

The IRS may collect this penalty from a responsible person from whom it can collect most easily, rather than from the person with the greatest culpability for the failure. It would accordingly promote fairness in the administration of the tax laws to establish a right of contribution among multiple responsible parties.

Explanation of Provision

If more than one person is liable for this penalty, each person who paid the penalty is entitled to recover from other persons who are liable for the penalty an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty. This proceeding is a Federal cause of action and must be entirely separate from any proceeding involving IRS's collection of the penalty from any responsible party (including a proceeding in which the United States files a counterclaim or third-party complaint for collection of the penalty).

Effective Date

The provision applies to penalties assessed after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

d. Board members of tax-exempt organizations (sec. 904 of TBOR 2 and sec. 6672 of the Code)

Present and Prior Law

Under section 6672, "responsible persons" of tax-exempt organizations are subject to a penalty equal to the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Reasons for Change

Individuals who serve on the boards of tax-exempt organizations, on a voluntary or honorary basis, are often concerned that they will

be held liable for unpaid taxes of the organization as a responsible person, even though their service may be strictly voluntary in nature, and they may not be involved in the day-to-day operations and financial decisions of the organization. The Congress believed that the IRS has not made adequate efforts to clarify the rules applicable to tax-exempt organizations.

Explanation of Provision

TBOR 2 clarifies that the section 6672 responsible person penalty is not to be imposed on volunteer, unpaid members of any board of trustees or directors of a tax-exempt organization to the extent such members are solely serving in an honorary capacity, do not participate in the day-to-day or financial activities of the organization, and do not have actual knowledge of the failure. The provision cannot operate in such a way as to eliminate all responsible persons from responsibility.

TBOR 2 requires the IRS to develop materials to better inform board members of tax-exempt organizations (including voluntary or honorary members) that they may be treated as responsible persons. The IRS is required to make such materials routinely available to tax-exempt organizations. TBOR 2 also requires the IRS to clarify its instructions to IRS employees on application of the responsible person penalty with regard to honorary or volunteer members of boards of trustees or directors of tax-exempt organizations.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

10. Modifications of rules relating to summonses

a. Enrolled agents included as third-party recordkeepers (sec. 1001 of TBOR 2 and sec. 7609 of the Code)

Present and Prior Law

Section 7609 contains special procedures that the IRS must follow before it issues a third- party summons. A third-party summons is a summons issued to a third-party recordkeeper compelling him to provide information with respect to the taxpayer. An example of this would be a summons served on a stock brokerage house to provide data on the securities trading of the taxpayer-client.

If a third-party summons is served on a third-party recordkeeper listed in section 7609(a)(3), then the taxpayer must receive notice of the summons and have an opportunity to challenge the summons in court. Otherwise the taxpayer has no statutory right to receive notice of the summons and accordingly he will not have the opportunity to challenge it in court.

Section 7609(a)(3) lists attorneys and accountants as third-party recordkeepers, but it does not list "enrolled agents," who are authorized to practice before the IRS.

Reasons for Change

Because enrolled agents are authorized to practice before the IRS in a similar manner to attorneys and accountants, the Congress believed that they should be accorded the same status as third-party recordkeepers as are attorneys and accountants.

Explanation of Provision

TBOR 2 includes enrolled agents as third-party recordkeepers.

Effective Date

The provision applies to summonses issued after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

b. Safeguards relating to designated summonses; annual report to Congress on designated summonses (secs. 1002 and 1003 of TBOR 2 and sec. 6503 of the Code)

Present and Prior Law

The period for assessment of additional tax with respect to most tax returns, corporate or otherwise, is three years. The IRS and the taxpayer can together agree to extend the period, either for a specified period of time or indefinitely. The taxpayer may terminate an indefinite agreement to extend the period by providing notice to the IRS.

During an audit, the IRS may informally request that the taxpayer provide additional information necessary to arrive at a fair and accurate audit adjustment, if any adjustment is warranted. Not all taxpayers cooperate by providing the requested information on a timely basis. In some cases the IRS seeks information by issuing an administrative summons. Such a summons will not be judicially enforced unless the Government (as a practical matter, the Department of Justice) seeks and obtains an order for enforcement in Federal court. In addition, a taxpayer may petition the court to quash an administrative summons where this is permitted by statute.[31]

In certain cases, the running of the assessment period is suspended during the period when the parties are in court to obtain or avoid judicial enforcement of an administrative summons. Such a suspension is provided in the case of litigation over a third-party summons (sec. 7609(e)) or litigation over a summons regarding the examination of a related party transaction. Such a suspension can

[31] Petitions to quash are permitted, for example, in connection with the examination of certain related party transactions under section 6038A(e)(4), and in the case of certain third-party summonses under section 7609(b)(2).

also occur with respect to a corporate tax return if a summons is issued at least 60 days before the day on which the assessment period (as extended) is scheduled to expire. In this case, suspension is only permitted if the summons clearly states that it is a "designated summons" for this purpose. Only one summons may be treated as a designated summons for purposes of any one tax return. The limitations period is suspended during the judicial enforcement period of the designated summons and of any other summons relating to the same tax return that is issued within 30 days after the designated summons is issued.

Under current internal procedures of the IRS, no designated summons is issued unless first reviewed by the Office of Chief Counsel to the IRS, including review by an IRS Deputy Regional Counsel for the Region in which the examination of the corporation's return is being conducted.

Reasons for Change

The Congress recognized that issuance of a designated summons is a serious step in the examination of a tax return, given the fact that litigation over the summons would suspend the running of the period for assessing additional tax against the taxpayer under audit. The Congress believed that, in recognition of the seriousness of such a step, the IRS should be required to institute additional procedures to ensure high-level IRS review before any such summons is issued. The Congress also believed that it is important to place some restrictions on the taxpayers to whom IRS can issue a designated summons.

Explanation of Provision

TBOR 2 requires that issuance of any designated summons with respect to a corporation's tax return must be preceded by review of such issuance by the Regional Counsel, Office of Chief Counsel to the IRS, for the Region in which the examination of the corporation's return is being conducted.

TBOR 2 also limits the use of a designated summons to corporations (or to any other person to whom the corporation has transferred records) that are being examined as part of the Coordinated Examination Program (CEP) or its successor. CEP audits cover about 1,600 of the largest corporate taxpayers. If a corporation moves between CEP and non-CEP audit categories, only the tax years covered by the CEP may be the subject of a designated summons. TBOR 2 does not affect Code section 6038A(e)(1), which relates to a U.S. reporting corporation that acts merely as the agent of the foreign related party by receiving summonses on behalf of the foreign party.

TBOR 2 also requires that the Treasury report annually to the Congress on the number of designated summonses issued in the preceding 12 months.

Effective Date

The provision applies to summonses issued after date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

11. Relief from retroactive application of Treasury Department regulations (sec. 1101 of TBOR 2 and sec. 7805 of the Code)

Prior Law

Under section 7805(b), Treasury may prescribe the extent (if any) to which regulations shall be applied without retroactive effect.

Reasons for Change

The Congress believed that it is generally inappropriate for Treasury to issue retroactive regulations.

Explanation of Provision

TBOR 2 provides that temporary and proposed regulations must have an effective date no earlier than the date of publication in the Federal Register or the date on which any notice substantially describing the expected contents of such regulation is issued to the public. Any regulations filed or issued within 18 months of the enactment of the statutory provision to which the regulation relates may be issued with retroactive effect. This general prohibition on retroactive regulations may be superseded by a legislative grant authorizing the Treasury to prescribe the effective date with respect to a statutory provision. The Treasury may issue retroactive temporary or proposed regulations to prevent abuse. The Treasury also may issue retroactive temporary, proposed, or final regulations to correct a procedural defect in the issuance of a regulation. Treasury may provide that taxpayers may elect to apply a temporary or proposed regulation retroactively from the date of publication of the regulation. Final regulations may take effect from the date of publication of the temporary or proposed regulation to which they relate. The provision does not apply to any regulation relating to internal Treasury Department policies, practices, or procedures. Prior law with respect to rulings is unchanged.

Effective Date

The provision applies with respect to regulations that relate to statutory provisions enacted on or after the date of enactment.

Revenue Effect

The provision is estimated to have no revenue effect in 1996, to reduce Federal fiscal year budget receipts by $1 million in 1997, by $4 million per year for 1998 to 2002, and $5 million per year for 2003 to 2006.

12. Miscellaneous provisions

a. Phone numbers of person providing payee statement required to be shown on such statement (sec. 1201 of TBOR 2 and secs. 6041, 6041A, 6042, 6044, 6045, 6049, 6050B, 6050H, 6050I, 6050J, 6050K and 6050N of the Code)

Present and Prior Law

Information returns must contain the name and address of the payor.

Reasons for Change

Taxpayers often need to contact payors issuing information returns in order to resolve questions about the accuracy of the information provided to the IRS. Previously, payors were only required to provide their names and addresses on information returns. As a result, taxpayers may have had difficulty in contacting the payor and resolving questions quickly.

Explanation of Provision

TBOR 2 requires that information returns contain the name, address, and phone number of the information contact of the person required to make the information return. A payor may, for example, provide the phone number of the department with the relevant information. It is intended that the telephone number provide direct access to individuals with immediate resources to resolve a taxpayer's questions in an expeditious manner.

Effective Date

The provision applies to statements required to be furnished after December 31, 1996 (determined without regard to any extension).

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

b. Required notice to taxpayers of certain payments (sec. 1202 of TBOR 2)

Prior Law

If the IRS receives a payment without sufficient information to properly credit it to a taxpayer's account, the IRS may attempt to contact the taxpayer. If contact cannot be made, the IRS places the payment in an unidentified remittance file.

Reasons for Change

If the IRS cannot associate a taxpayer's payment with a balance due, the IRS generally deposits the money and may not inform the taxpayer of the overpayment. For example, a check that is sepa-

rated from a balance-due income tax return, which is subsequently lost, may not get credited to that taxpayer's account.

Explanation of Provision

TBOR 2 requires the IRS to make reasonable efforts to notify, within 60 days, those taxpayers who have made payments which the IRS cannot associate with the taxpayer.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

c. Unauthorized enticement of information disclosure (sec. 1203 of TBOR 2 and new sec. 7435 of the Code)

Prior Law

No statutory disincentive applied to IRS employees who entice a tax professional to disclose information about clients in exchange for the favorable treatment of the taxes of the professional.

Reasons for Change

The Congress believed that it is improper for IRS employees to entice tax professionals into breaching their fiduciary responsibilities to their clients in exchange for favorable treatment on their own returns.

Explanation of Provision

If any officer or employee of the United States intentionally compromises the determination or collection of any tax due from an attorney, certified public accountant, or enrolled agent representing a taxpayer in exchange for information conveyed by the taxpayer to the attorney, certified public accountant, or enrolled agent for purposes of obtaining advice concerning the taxpayer's tax liability, the taxpayer may bring a civil action for damages against the United States in a district court of the United States. Upon a finding of liability, damages shall equal the lesser of $500,000 or the sum of (1) actual economic damages sustained by the taxpayer as a proximate result of the information disclosure and (2) the costs of the action. These remedies shall not apply to information conveyed to an attorney, certified public accountant, or enrolled agent for the purpose of perpetrating a fraud or crime.

Effective Date

The provision applies to actions taken after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

d. Annual reminders to taxpayers with outstanding delinquent accounts (sec. 1204 of TBOR 2 and new sec. 7524 of the Code)

Prior Law

There was no statutory requirement in the Code that the IRS send annual reminders to persons who have outstanding tax liabilities.

Reasons for Change

Numerous taxpayers become delinquent in paying their tax liability. The delinquencies may occur because the person did not make enough payments through payroll withholding or quarterly estimated payments or because of an adjustment following an audit.

The IRS generally pursues larger tax deficiencies first, and then it pursues small deficiencies. Because of the limited amount of IRS resources to work collection cases, cases with smaller deficiencies may not be addressed for years. In the meantime, the taxpayer may come to believe that the apparent lack of IRS collection activity means that it has abandoned its claim against the taxpayer. The taxpayer may be surprised when the IRS resumes collection action years later, when the 10-year statute of limitations on collections is close to expiring.

Explanation of Provision

TBOR 2 requires the IRS to send taxpayers an annual reminder of their outstanding tax liabilities. The fact that a taxpayer did not receive a timely, annual reminder notice does not affect the tax liability.

Effective Date

The provision requires the IRS to send annual reminder notices beginning in 1997.

Revenue Effect

The provision is estimated to have no revenue effect in 1996, and to increase Federal fiscal year budget receipts by less than $1 million per year for 1997 to 2006.

e. Five-year extension of authority for undercover operations (sec. 1205 of TBOR 2 and sec. 7608 of the Code)

Prior Law

The Anti-Drug Abuse Act of 1988 exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts be deposited in the general fund of the Treasury and all

expenses be paid out of appropriated funds). In general, the exemption permited the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS was required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. The IRS has not had the authority to churn funds from its undercover operations since 1991.

Reasons for Change

Many other law enforcement agencies have churning authority. The Congress believed that it is appropriate for IRS to have this authority as well.

Explanation of Provision

TBOR 2 reinstates the IRS's offset authority under section 7608(c) from the date of enactment until January 1, 2001. TBOR 2 amends the IRS annual reporting requirement under section 7608(c)(4)(B) to require the provision of the following data: (1) the date the operation was initiated; (2) the date offsetting was approved; (3) the total current expenditures and the amount and use of proceeds of the operation; (4) a detailed description of the undercover operation projected to generate proceeds, including the potential violation being investigated, and whether the operation is being conducted under grand jury auspices; and (5) the results of the operation to date, including the results of criminal proceedings.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $1 million per year for 1996 to 2006.

f. Disclosure of returns on cash transactions (sec. 1206 of TBOR 2 and sec. 6103 of the Code)

Present and Prior Law

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

Under section 6050I, any person who receives more than $10,000 in cash in one transaction (or two or more related transactions) in

the course of a trade or business generally must file an information return (Form 8300) with the IRS specifying the name, address, and taxpayer identification number of the person from whom the cash was received and the amount of cash received.

The Anti-Drug Abuse Act of 1988 provided a special rule permitting the IRS to disclose these information returns to other Federal agencies for the purpose of administering Federal criminal statutes. The special rule originally was to expire after November 18, 1990, and was extended by the Comprehensive Crime Control Act of 1990 to November 18, 1992.

Reasons for Change

Because information filed on Form 8300 is very similar to information filed on Currency Transaction Reports (CTRs) under the Bank Secrecy Act, the Congress believed that both types of information reports should be subject to the same disclosure rules.

Explanation of Provision

TBOR 2 permanently extends the special rule for disclosing Form 8300 information. Moreover, the permits disclosures not only to Federal agencies but also to State, local and foreign agencies and for civil, criminal and regulatory purposes (i.e., generally in the same manner as Currency Transaction Reports filed by financial institutions under the Bank Secrecy Act). Disclosure, however, is not permitted to any such agency for purposes of tax administration. TBOR 2 also (1) extends the dissemination policies and guidelines under section 6103 to people having access to Form 8300 information, and (2) applies section 6103 sanctions to persons having access to Form 8300 information that disclose this information without proper authorization.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

g. Disclosure of returns and return information to designee of taxpayer (sec. 1207 of TBOR 2 and sec. 6103 of the Code)

Prior Law

Under prior law, the IRS was authorized to disclose the return of any taxpayer, or return information pertaining to a taxpayer, to such person(s) as the taxpayer has designated in a written request.

Reasons for Change

The Congress believed that the IRS's move to a paperless system depends on the ease and functionality of electronic communication systems (e.g., telephones, facsimile machines, computers, communications networks, etc.)

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Explanation of Provision

TBOR 2 deletes the word "written" from the requirement that "written consent" from the taxpayer is necessary for the disclosure of taxpayer information to a designated third party. Allowing the IRS to adopt alternatives to the written request requirement will expedite such changes and facilitate the development and implementation of Tax System Modernization projects. It is anticipated that the IRS will continue to utilize its regulatory authority to impose reasonable restrictions on the form in which a request is made, and that the IRS will in no event accept an unconfirmed verbal request.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

h. Report on netting of interest on overpayments and liabilities (sec. 1208 of TBOR 2)

Present and Prior Law

If any portion of a tax is satisfied through the crediting of an overpayment of tax, no interest is imposed on that portion of the tax for any period during which, if the credit had not been made, interest would have been allowable.

The Tax Reform Act of 1986 first implemented an interest rate differential. The underpayment rate was set 1 percent higher than the overpayment rate. The Conference Report to the Tax Reform Act of 1986 stated:

> [t]o the extent a portion of tax due is satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax. Consequently, if an underpayment of $1,000 occurs in year 1, and an overpayment of $1,000 occurs in year 2, no interest is imposed in year 2 because of the rule of section 6601(f). The IRS can at present net many of these offsetting overpayments and underpayments. Nevertheless, the IRS will require a transition period during which to coordinate differential interest rates . . . [t]he Secretary of the Treasury may prescribe regulations providing for netting of tax underpayments and overpayments through the period ending three years after the date of enactment of TBOR 2. By that date, the IRS should have implemented the most comprehensive netting procedures that are consistent with sound administrative practice.

The Omnibus Budget Reconciliation Act of 1990 increased the underpayment rate on certain large corporate underpayments to 3 percent higher than the overpayment rate. The Conference Report stated:

> Under present law, the Secretary has the authority to credit the amount of any overpayment against any liability under the Code . . . to the extent a portion of tax due is

> satisfied by a credit of an overpayment, no interest is imposed on that portion of the tax . . . The Secretary should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice.

The General Agreement on Tariffs and Trade (GATT) reduced the overpayment rate on certain corporate tax refunds. The legislative history of the GATT legislation stated that:

> The Secretary of the Treasury should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice, and should do so as rapidly as is practicable.

Reasons for Change

The Congress believed that it is important for the Congress to understand in detail how the IRS has implemented netting procedures to date. Congress has never adopted differential interest rates, or increased the amount of such differential, without at the same time also encouraging the IRS to implement comprehensive interest netting procedures. The Congress was concerned that the IRS has failed to implement comprehensive interest netting procedures and is interested in learning whether the delay stems from technical difficulties or substantive questions about the scope of such interest netting procedures.

Explanation of Provision

TBOR 2 requires the Secretary of the Treasury to conduct a study of the manner in which the IRS has implemented the netting of interest on overpayments and underpayments and the policy and administrative implications of global netting. The Treasury is required to hold a public hearing to receive comments from any interested party prior to submitting the report of its study to the tax writing committees.

Effective Date

The report is due six months after the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

i. Expenses of detection of underpayments and fraud (sec. 1209 of TBOR 2 and sec. 7623 of the Code)

Present and Prior Law

The Secretary may, pursuant to regulations, pay rewards for information leading to the detection and punishment of violations of the Internal Revenue laws.

Reasons for Change

The Congress believed that improvements should be made to this program.

Explanation of Provision

TBOR 2 clarifies that rewards may be paid for information relating to civil violations, as well as criminal violations. TBOR 2 also provides that the rewards are to be paid out of the proceeds of amounts (other than interest) collected by reason of the information provided. TBOR 2 also requires an annual report on the rewards program.

Effective Date

The provision is effective six months after the date of enactment.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

j. Use of private delivery services for timely-mailing-as-timely-filing rule (sec. 1210 of TBOR 2 and sec. 7502 of the Code)

Present and Prior Law

The Code sets forth the rules for determining when a return, payment of tax, or other document required to be filed with the IRS is deemed to be filed or delivered on a timely basis (sec. 7502). In a recent case interpreting this section (*V.L.Correia,* 58 F.3d 468 (1995)), the U.S. Court of Appeals for the 9th Circuit upheld the Tax Court's ruling that the section's so-called "timely-mailing as timely-filing" rule does not apply to private delivery companies. Although the Appeals Court agreed that there is a legitimate policy rationale for extending the rule to private delivery companies, it concluded that only Congress, and not the courts, had the power to make such a change.

Reasons for Change

There are many private delivery companies operating today which meet the U.S. Postal Service's ability to deliver documents quickly and securely. The Congress believed that every year, many taxpayers needlessly run afoul of the prior-law rule because they make a reasonable assumption that using a private delivery service is adequate to show timely filing of their tax returns.

Explanation of Provision

The Secretary of the Treasury is given authority to expand the "timely-mailing as timely-filing" rule to include a designated delivery service. A designated delivery service must be designated as such by the Secretary. The Secretary may designate a delivery service only if it meets the following criteria: (1) it is available to the general public; (2) it is at least as timely and reliable on a regular basis as the United States mail; (3) it satisfies recordkeeping criteria; and (4) it meets any additional criteria as the Secretary may prescribe. The provision also gives the Secretary similar authority with respect to equivalents for United States certified or registered mail.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

k. Reports on misconduct by IRS employees (sec. 1211 of TBOR 2)

Present and Prior Law

The IRS Inspection Division investigates allegations of criminal misconduct or serious violations of the "Standards of Ethical Conduct for Employees of the Executive Branch" (5 CFR 2635) by IRS employees. In addition, IRS management addresses other types of taxpayer complaints relating to inappropriate behavior by IRS employees.

Reasons for Change

Criminal actions resulting from Inspection Service investigations are a matter of public record, and press releases are issued in conjunction with the U.S. Attorney's office about such matters in accordance with exceptions that exist to tax disclosure and privacy constraints. However, information about administrative disciplinary actions are generally not available to the public. The Congresss believed that this may lead to a public perception that allegations of misconduct by IRS employees are not investigated or that misconduct goes unpunished.

Explanation of Provision

TBOR 2 requires the IRS to make an annual report to the taxwriting committees, beginning June 1, 1997, on all categories of instances involving allegations of misconduct by IRS employees, arising either from internally identified cases or from taxpayer or third-party initiated complaints. The report must identify by IRS Region and primary activity involved (e.g., examination, collection, etc.), the nature of the misconduct or complaint, the number of instances received by category, and the disposition of these instances. This would include, but not be limited to, the following categories: number of employees reprimanded, terminated, or prosecuted; instances dismissed because of a finding that proper procedures were followed; and those initiated but not yet resolved. Instances covered by this process must include both written complaints of misconduct and those received by telephone through management channels. Each annual report will cover instances of misconduct that occurred during the preceding calendar year. Disposition of complaints not resolved by the time the report is prepared must be included in the report for the year in which resolution occurs.

Effective Date

The first report is due by June 1, 1997.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

B. Revenue Offsets

1. Application of failure-to-pay penalty to substitute returns (sec. 1301 of TBOR 2 and sec. 6651 of the Code)

Present and Prior Law

Section 6651(a)(2) provides that the IRS may assess a penalty for failure to pay tax from the due date of the return until the tax is paid. If no return is filed by the taxpayer and the IRS files a substitute return under section 6020, the tax on which the penalty is measured is considered a deficiency assessable under section 6212 or 6213, and the failure to pay penalty began to accumulate 10 days after the IRS sends the taxpayer a notice and demand for payment of the tax.

Reasons for Change

Under the prior penalty system, there was an inequity between voluntarily filed delinquent returns and substitute returns. Taxpayers who file delinquent returns must pay a failure to file penalty from the due date of the return, whereas the taxpayer who forces the IRS to utilize a substitute return was not assessed the penalty until billed by the IRS.

Explanation of Provision

TBOR 2 applies the failure to pay penalty to substitute returns in the same manner as the penalty applies to delinquent filers.

Effective Date

The provision applies in the case of any return the due date for which (determined without regard to extensions) is after the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1996, $3 million in 1997, $29 million in 1998, $30 million in 1999, $32 million in 2000, $33 million in 2001, $35 million in 2002, $37 million in 2003, $38 million in 2004, $40 million in 2005, and $42 million in 2006.

2. Excise taxes on amounts of private excess benefits (secs. 1311-1314 of TBOR2 and secs. 501, 6033, 6104, 6652, 6685 and new secs. 4958, 6116, and 6716 of the Code)

Present and Prior Law

Private inurement

Charities.—Section 501(c)(3) specifically conditions tax-exempt status for all organizations described in that section on the requirement that no part of the net earnings of the organization inures to

the benefit of any private shareholder or individual (the so-called "private inurement test").

Social welfare organizations.—A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a nonprofit basis and must be operated exclusively for the promotion of social welfare. In contrast to section 501(c)(3), however, there is no specific statutory rule in section 501(c)(4) prohibiting the net earnings of a social welfare organization described in section 501(c)(4) from inuring to the benefit of a private shareholder or individual.[32]

Other organizations.—Other tax-exempt organizations, such as labor and agricultural organizations described in section 501(c)(5) and business leagues described in section 501(c)(6) are subject to the private inurement test, as a result of explicit statutory language or Treasury Department regulations.

Sanctions for private inurement and other violations of exemption standards

Organizations described in section 501(c)(3) are classified as either public charities or private foundations. Penalty excise taxes may be imposed under the Code when a public charity makes political expenditures (sec. 4955) or excessive lobbying expenditures (secs. 4911 and 4912). However, the Code generally does not provide for the imposition of penalty excise taxes in cases where a 501(c)(3) public charity or a section 501(c)(4) social welfare organization engages in a transaction that results in private inurement. In such cases, the only sanction that specifically is authorized under the Code is revocation of the organization's tax-exempt status. A transaction engaged in by a private foundation (but not a public charity) is subject to special penalty excise taxes under the Code if the transaction is a prohibited "self-dealing" transaction (sec. 4941) or does not accomplish a charitable purpose (sec. 4945).

Filing and public disclosure rules

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year. Private foundations are required to allow public inspection at the foundation's principal office of their current annual information return. Other tax-exempt organizations, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (sec. 6104(e)). The Code also requires that tax-exempt organizations allow public inspection of the organization's application to the IRS for recognition of tax-exempt status, the IRS determination letter, and certain related documents. In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information re-

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[32] Even where no prohibited private inurement exists, however, more than incidental private benefits conferred on individuals may result in the organization not being operated "exclusively" for an exempt purpose. See, e.g., *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

turns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

Section 6652(c)(1)(A) provides that a tax-exempt organization that fails to file a complete and accurate Form 990 is subject to a penalty of $10 for each day during which such failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts for the year). Section 6652(c)(1)(C) and section 6652(c)(1)(D) provide that tax-exempt organizations that fail to make certain annual returns and applications for exemption available for public inspection are subject to a penalty of $10 for each day the failure continues (with a maximum penalty with respect to any one return not to exceed $5,000, and without limitation with respect to applications). In addition, section 6685 provides a penalty for willfully failing to make an annual return or application available for public inspection of $1,000 per return or application.

Reasons for Change

To ensure that the advantages of tax-exempt status ultimately benefit the community and not private individuals, TBOR 2 extended the present-law section 501(c)(3) private inurement prohibition to nonprofit organizations described in section 501(c)(4) and provided for intermediate sanctions that may be imposed when nonprofit organizations described in section 501(c)(3) or 501(c)(4) engage in transactions with certain insiders that result in private inurement. TBOR 2 also enhanced the oversight and public accountability of nonprofit organizations through additional reporting of information by nonprofit organizations to the Internal Revenue Service (IRS) and increased public access to documents filed by such organizations with the IRS.

Explanation of Provisions

Extend private inurement prohibition to social welfare organizations

TBOR 2 amends section 501(c)(4) explicitly to provide that a social welfare organization or other organization described in that section will be eligible for tax-exempt status only if no part of its net earnings inures to the benefit of any private shareholder or individual.

In addition, TBOR 2 provides that the private inurement rule will not be violated solely because of an allocation or return of net margins or capital to the members of a nonprofit association or organization that operates on a cooperative basis in accordance with its incorporating statute and bylaws (substantially as in existence on the date of enactment) and was determined to be exempt from Federal income tax under section 501(c)(4) prior to the date of enactment. However, such cooperative organizations are subject to

the general private inurement proscription with respect to any other type of transaction.

Intermediate sanctions for excess benefit transactions

TBOR 2 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations, which are subject to a separate penalty regime under current law) engage in an "excess benefit transaction." In such cases, intermediate sanctions may be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

An "excess benefit transaction" is defined as: (1) any transaction in which an economic benefit is provided to, or for the use of, any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity[33]) to such person exceeds the value of consideration (including performance of services) received by the organization for providing such benefit; and (2) to the extent provided in Treasury Department regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition. The Treasury Department is instructed to issue prompt guidance providing examples of revenue-sharing arrangements that violate the private inurement prohibition; such guidance shall be applicable on a prospective basis.[34]

Existing tax-law standards (see sec. 162) apply in determining reasonableness of compensation and fair market value.[35] In applying such standards, the Congress intended that the parties to a transaction are entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if such arrangement was approved by a board of directors or trustees (or committee thereof) that: (1) was composed entirely of individuals unrelated to and not subject to the

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[33] A tax-exempt organization cannot avoid the private inurement proscription by causing a controlled entity to engage in an excess benefit transaction. Thus, for example, if a tax-exempt organization causes its taxable subsidiary to pay excessive compensation to an individual who is a disqualified person with respect to the parent organization, such transaction would be an excess benefit transaction.

[34] Under present law, certain revenue sharing arrangements have been determined not to constitute private inurement (see e.g., GCM 38283; GCM 38905; and GCM 39674) and, under the proposal, it would continue to be the case that not all revenue sharing arrangements would be improper private inurement. However, the Congress intended no inference that Treasury or the Internal Revenue Service are bound by any particular prior unpublished rulings in this area.

[35] In this regard, the Congress intended that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization. Cf. Treas. Reg. sec. 53.4941(d)-3(c)(1).

control of the disqualified person(s) involved in the arrangement;[36] (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).[37] If these three criteria are satisfied, penalty excise taxes could be imposed under the proposal only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (e.g., the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position). A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination. The Secretary of the Treasury and IRS are instructed to issue guidance in connection with the reasonableness standard that incorporates this presumption.

TBOR 2 specifically provides that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons, will be treated as compensation only if it is clear that the organization intended and made the payments as compensation for services. In determining whether such payments or transactions are, in fact, compensation, the relevant factors include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer as compensation to the extent required on the relevant forms (i.e., the organization's Form 990, the Form W-2 or Form 1099 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).[38]

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[36] A reciprocal approval arrangement whereby an individual approves compensation of the disqualified person, and the disqualified person, in turn, approves the individual's compensation does not satisfy the independence requirement.

[37] The fact that a State or local legislative or agency body may have authorized or approved of a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation paid for purposes of the excise tax penalties provided for by the proposal. Similarly, such authorization or approval is not determinative of whether a revenue sharing arrangement violates the private inurement proscription.

[38] With the exception of nontaxable fringe benefits described in present-law section 132 and other types of nontaxable transfers such as employer-provided health benefits and contributions to qualified pension plans, an organization cannot demonstrate at the time of an IRS audit that it clearly indicated its intent to treat economic benefits provided to a disqualified person as compensation for services merely by claiming that such benefits may be viewed as part of the disqualified person's total compensation package. Rather, the organization would be required to provide substantiation that is contemporaneous with the transfer of economic benefits at issue.

Consistent with the rule that payment of personal expenses and benefits to or for the benefit of disqualified persons and nonfair-market value transactions benefiting such persons are treated as compensation only if it is clear that the organization intended and made the payments as compensation for services, any reimbursements by the organization of excise tax liability are treated as an excess benefit unless they are included in the disqualified person's compensation during the year the reimbursement is made. The total compensation package, including the amount of any reimbursement, is subject to the reasonableness requirement. Similarly, the payment by an applicable tax-exempt organization of premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes is an excess benefit transaction unless such premiums are treated as part of a total compensation package that satisfies the reasonableness requirement.[39]

"Disqualified person" means any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization manager or otherwise.[40] In addition, "disqualified persons" include certain family members and 35-percent owned entities[41] of a disqualified person, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue. A person having the title of "officer, director, or trustee" does not automatically have the status of a disqualified person.[42] In addition, the Secretary of Treasury has authority to promulgate rules exempting broad categories of individuals from the category of "disqualified persons" (e.g., full-time bona fide employees who receive economic benefits of less than a threshold amount or persons who have taken a vow of poverty).

A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e., the amount by which a transaction differs from fair market value, the amount of compensation exceeding reasonable compensation, or (under Treasury regulations) the amount of a prohibited transaction based on the organi-

[39] In addition, because individuals may be both members of, and disqualified persons with respect to, a non-exclusive applicable tax-exempt organization (e.g., a museum or neighborhood civic organization) and receive certain benefits (e.g., free admission, discounted gift shop purchases) in their capacity as members (rather than in their capacity as disqualified persons), the Congress expected that the Treasury Department will provide guidance clarifying that such membership benefits may be excluded from consideration under the private inurement proscription and intermediate sanction rules.

[40] Under TBOR 2, a person could be in a position to exercise substantial influence over a tax-exempt organization despite the fact that such person is not an employee of (and receives no compensation directly from) a tax-exempt organization, but is formally an employee of (and is directly compensated by) a subsidiary—even a taxable subsidiary—controlled by the parent tax-exempt organization.

[41] Family members are determined under present-law section 4946(d), except that such members also would include siblings (whether by whole or half blood) of the individual, and spouses of such siblings. "35-percent owned entities" mean corporations in which disqualified persons own stock possessing more than 35 percent of the combined voting power, as well as partnerships and trusts or estates in which disqualified persons own more than 35 percent of the profits interest or beneficial interest. As under present-law section 4946(a), the term "combined voting power" includes voting power represented by holdings of voting stock, actual or constructive, but does not include voting rights held only as a director or trustee. See Treas. Reg. sec. 53.4946-1(a)(5).

[42] The IRS has issued a general counsel memorandum indicating that all physicians are considered "insiders" for purposes of applying the private inurement proscription. The Congress intended that physicians will be disqualified persons only if they are in a position to exercise substantial influence over the affairs of an organization.

zation's gross or net income). Organization managers who participate in an excess benefit transaction knowing that it is an improper transaction are subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit (subject to a maximum penalty of $10,000).[43]

Additional, second-tier taxes may be imposed on a disqualified person if there is no correction of the excess benefit transaction within a specified time period.[44] In such cases, the disqualified person is subject to a penalty tax equal to 200 percent of the amount of excess benefit. For this purpose, the term "correction" means undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

The intermediate sanctions for "excess benefit transactions" may be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.[45] If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons are jointly and severally liable for such tax. As under current law, a three-year statute of limitations applies, except in the case of fraud (sec. 6501). Under TBOR 2, the IRS has authority to abate the excise tax penalty (under present-law section 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.[46]

To prevent avoidance of the penalty excise taxes in cases of private inurement of assets of a previously tax-exempt organization, the TBOR 2 provides that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the 5-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization.

Additional filing and public disclosure rules

Reporting of information with respect to certain disqualified persons, excise tax penalties and excess benefit transactions.—Tax-exempt organizations are required to disclose on their Form 990 such information with respect to disqualified persons as the Secretary of the Treasury may prescribe. The Congress intended that this re-

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[43] In determining who is an organization manager, the Congress intended that principles similar to those set forth in regulations issued under sections 4946 and 4955 with respect to final authority or responsibility for an expenditure be applied. (See Treas. Reg. secs. 53.4946-1(f)(1)(ii), 53.4946-1(f)(2), 53.4955-1(b)(2)(ii)(B), and 53.4955-1(b)(2)(iii)).

[44] Correction must be made on or prior to the earlier of (1) the date of mailing of a notice of deficiency under section 6212 with respect to the first-tier penalty excise tax imposed on the disqualified person, or (2) the date on which such tax is assessed.

[45] In general, the intermediate sanctions are the sole sanction to be imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

[46] TBOR 2 made conforming changes to the definitions contained in section 4963, by listing the new section 4958 excise taxes among other intermediate sanction, excise tax penalties. However, a technical correction is needed to section 4962(b) to clarify that the first tier, section 4958 excise taxes—which are contained in new subchapter D of chapter 42 of the Internal Revenue Code—may be abated by the IRS.

quirement is not intended to limit the Secretary's authority under section 6033(a)(1) to require information on annual returns filed by exempt organizations for the purpose of carrying out the internal revenue laws. In addition, exempt organizations are required to disclose on their Form 990 such information as the Secretary of the Treasury may require with respect to "excess benefit transactions" (described above) and any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.[47]

Furnishing copies of documents.—TBOR 2 also provides that a tax-exempt organization that is subject to the public inspection rules of present-law section 6104(e)(1) (i.e., any tax-exempt organization, other than a private foundation, that files a Form 990) is required to comply with requests made in writing or in person from individuals who seek a copy of the organization's Form 990 or the organization's application for recognition of tax-exempt status and certain related documents. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If so requested, copies must be supplied of the Forms 990 for any of the organization's three most recent taxable years. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. However, an organization may be relieved of its obligation to provide copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest.

Penalties for failure to file timely or complete return.—The section 6652(c)(1)(A) penalty imposed on a tax-exempt organization that either fails to file a Form 990 in a timely manner or fails to include all required information on a Form 990 is increased from the present-law level of $10 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts) to $20 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $10,000 or five percent of the organization's gross receipts). Under TBOR 2, organizations with annual gross receipts exceeding $1 million are subject to a penalty under section 6652(c)(1)(A) of $100 for each day the failure continues (with a maximum penalty with respect to any one return of $50,000). As under present law, no penalty may be imposed

[47] The penalties applicable to failure to file a timely, complete, and accurate return apply for failure to comply with these requirements. In addition, the Congress intended that the IRS implement its plan to require additional Form 990 reporting regarding (1) changes to the governing board or the certified accounting firm, (2) such information as the Treasury Secretary may require relating to professional fundraising fees paid by the organization, and (3) aggregate payments (by related entities) in excess of $100,000 to the highest-paid employees.

under section 6652(c)(1)(A) if it were shown that the failure to file a complete return was due to reasonable cause (sec. 6652(c)(3)).

Penalties for failure to allow public inspection or provide copies.—The section 6652(c)(1)(C) and section 6652(c)(1)(D) penalties imposed on tax-exempt organizations that fail to allow public inspection or provide copies of certain annual returns or applications for exemption are increased from the present-law level of $10 per day (with a maximum of $5,000) to $20 per day (with a maximum of $10,000).[48] In addition, the section 6685 penalty for willful failure to allow public inspections or provide copies is increased from the present-law level of $1,000 to $5,000.

Effective Dates

The provision extending the private inurement prohibition to organizations described in section 501(c)(4) generally is effective on September 14, 1995. However, under a special transition rule, the provision does not apply to inurement occurring prior to January 1, 1997, if such inurement results from a written contract that was binding on September 13, 1995, and at all times thereafter before such inurement occurred, and the terms of which have not materially changed.

The provisions imposing intermediate sanctions for excess benefit transactions generally apply to excess benefit transactions occurring on or after September 14, 1995. The provisions do not apply, however, to any benefits arising out of a transaction pursuant to a written contract which was binding on September 13, 1995, and at all times thereafter before such benefits arose, and the terms of which have not materially changed. In addition, the Congress intended that parties to transactions entered into after September 13, 1995, and before January 1, 1997, are entitled to rely on the rebuttable presumption of reasonableness if, within a reasonable period (e.g., 90 days) after entering into the compensation package, the parties satisfy the three criteria that give rise to the presumption.[49] After December 31, 1996, the rebuttable presumption should arise only if the three criteria are satisfied *prior* to payment of the compensation (or, to the extent provided by the Secretary of the Treasury, within a reasonable period thereafter).

The public inspection provisions governing tax-exempt organizations generally apply to requests made no earlier than 60 after the date on which the Treasury Department publishes the anti-harassment regulations required under the provisions. However, the Congress expected that organizations will comply voluntarily with the public inspection provisions prior to the issuance of such regulations. The provisions regarding the reporting on annual returns of excise tax penalties and excess benefit transactions are effective for

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[48] TBOR 2 contained a technical error in that it did not increase the section 6652(c)(1)(C) and section 6652(c)(1)(D) penalties as intended by Congress. However, this technical error was corrected by section 1704(s) of the Small Business Act.

[49] Due to the passage of time between the general effective date of September 14, 1995, and the enactment of TBOR 2 on July 30, 1996, it is anticipated that the IRS will take a flexible approach in applying a rebuttable presumption of reasonableness to transactions entered into after September 13, 1995, when the organization took steps that give rise to the presumption within a reasonable period after enactment of the legislation on July 30, 1996, but prior to January 1, 1997.

returns with respect to taxable years beginning on or after the date of enactment.

Revenue Effect

The provisions are estimated to increase Federal fiscal year budget receipts by $4 million for each year in 1996, 1997, and 1998, $5 million for each year in 1999, 2000, and 2001, and $6 million for each year in 2002, 2003, and 2004, and $7 million for each year in 2005 and 2006.

PART FOUR:

REVENUE PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 (H.R. 3448)[50]

I. SMALL BUSINESS AND OTHER TAX PROVISIONS

A. Small Business Provisions

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

Prior Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment could elect to deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[51] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Reasons for Change

The Congress believed that section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for tangible property used in a trade or business. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these benefits, the Congress, after a phase-in period, increased the amount allowed to be expensed under section 179 to $25,000.

The Congress also believed that horses should qualify as section 179 property. The Congress believed that horses are similar to

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[50] Public Law 104-188; signed on August 20, 1996.
H.R. 3448 was reported by the House Committee on Ways and Means on May 20, 1996 (H. Rept. 104-56), and was passed by the House, as amended, on May 22, 1996. The House amended H.R. 3448 by adding (as Title II) the minimum wage provisions of H.R. 1227. H.R. 3448, as amended, was reported by the Senate Committee on Finance on June 18, 1996 (S. Rept. 104-281), and was passed by the Senate, as amended, on July 9, 1996. The conference report was filed on August 1, 1996 (H. Rept. 104-737), and was approved by the House and the Senate on August 2, 1996.

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

other tangible personal property for which expensing is allowed and that any potential tax shelter abuses inherent in allowing the cost of a horse to be expensed are better addressed by the phase-out and taxable income limitations of section 179, the hobby loss rules of section 183, and the passive loss rules of section 469. Thus, the Congress did not adopt a technical correction that would have denied section 179 expensing for horses.

Explanation of Provision

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

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

The Small Business Act clarifies that horses are qualified property for purposes of section 179.

Effective Date

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

Revenue Effect

The provision (including the treatment of horses) is estimated to reduce Federal fiscal year budget receipts by $67 million in 1997, $180 million in 1998, $261 million in 1999, $331 million in 2000, $763 million in 2001, $938 million in 2002, $786 million in 2003, $646 million in 2004, $439 million in 2005, and $265 million in 2006.

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

Present and Prior Law

Under present and prior law, employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA"). Employees are required to report to the employer the amount of tips received. The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips treated as paid by the employer. The credit applies to tips received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees is customary. OBRA 1993 provided that the FICA tip credit is effective for taxes paid

after December 31, 1993. Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is allowed for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Reasons for Change

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

In 1993, the House and Senate versions of OBRA 1993 did not contain the FICA tip provision, but it was included in the conference agreement. The FICA tip provision that was included in OBRA 1993 had the same effective date as the provision in the conference agreement for H.R. 11, except that the date was moved one year, to taxes paid after December 31, 1993. The Congress believed that the legislative history of this provision indicated an intent to change the effective date, and that the Treasury's interpretation of that date is not consistent with the provision as finally adopted.

The Congress also believed it appropriate to apply the credit to tips received by all persons who provide food and beverages, including delivery of such food and beverages for consumption off the premises.

Explanation of Provision

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

The Small Business Act also modifies the credit so that it applies with respect to tips received from customers in connection with the provision of food or beverages, including the delivery for consumption off the premises of the establishment.

Effective Date

The clarifications relating to the effective date and nonreported tips are effective as if included in OBRA 1993. The provision expanding the tip credit to the provision of food or beverages not for consumption on the premises of the establishment is effective with respect to FICA taxes paid on tips received with respect to services performed after December 31, 1996.

Revenue Effect

The clarifications relating to the effective date and nonreported tips are estimated to have a negligible effect on Federal fiscal year budget receipts. The expansion of the credit to the provision of food or beverages not for consumption on the premises is estimated to reduce Federal fiscal year budget receipts as follows: $6 million in 1997, $14 million in 1998, $15 million in 1999, $16 million in 2000, $17 million in 2001, $18 million in 2002, $18 million in 2003, $19 million in 2004, $20 million in 2005, and $21 million in 2006.

3. Home office deduction: Treatment of storage of product samples (sec. 1113 of the Small Business Act and sec. 280A of the Code)

Present and Prior Law

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Code section 280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the Code further requires that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)). These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home (sec. 280A(f)(1)).

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (sec. 280A(c)(5)).

Reasons for Change

The Congress believed that present-law section 280A(c)(2) should be clarified so that taxpayers who sell products at retail or whole-

sale, and regularly store such products at home, need not attempt to distinguish between inventory and product samples. This clarification will simplify the administration of present-law section 280A(c)(2).

Explanation of Provision

The Small Business Act clarifies that the special rule contained in present-law section 280A(c)(2) permits deductions for expenses related to a storage unit in a taxpayer's home regularly used for inventory or product samples (or both) of the taxpayer's trade or business of selling products at retail or wholesale, provided that the home is the sole fixed location of such trade or business.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 per year.

4. Treatment of certain charitable risk pools (sec. 1114 of the Small Business Act and sec. 501(n) of the Code)

Prior Law

Organizations described in section 501(c)(3) (which are referred to as "charities") generally are exempt from Federal income tax and are eligible to receive tax-deductible contributions and to use the proceeds of tax-exempt financing. Section 501(c)(3) requires that an organization be organized and operated exclusively for a charitable or other specifically enumerated exempt purposes in order to qualify for tax-exempt status under that section.

Section 501(c)(3) provides that an organization that is organized and operated exclusively for charitable purposes is entitled to tax-exempt status under that section only if the organization satisfies the additional requirements that no part of its net earnings inures to the benefit of any private individual or shareholder (referred to as the "private inurement test") and only if the organization does not engage in political campaign activity on behalf of (or in opposition to) any candidate for public office and does not engage in substantial lobbying activities.

Section 501(m) provides that an organization described in section 501(c)(3) or 501(c)(4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. For purposes of this rule, commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients.

Prior law did not specifically accord tax-exempt status to an organization that pools insurable risks of a group of tax-exempt organizations described in section 501(c)(3).

Reasons for Change

The Congress believed that providing tax-exempt status to not-for-profit risk pools whose members are exclusively tax-exempt charitable organizations, and which obtain significant capital from nonmember charitable organizations, helps make liability insurance more affordable to charitable organizations.

Explanation of Provision

Under the Small Business Act, a qualified charitable risk pool is treated as organized and operated exclusively for charitable purposes. The provision makes inapplicable to a qualified charitable risk pool the present-law rule under section 501(m) that a charitable organization described in section 501(c)(3) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

The Small Business Act defines a qualified charitable risk pool as an organization organized and operated solely to pool insurable risks of its members (other than medical malpractice risks) and to provide information to its members with respect to loss control and risk management. Because a qualified charitable risk pool must be organized and operated *solely* to pool insurable risks of its members and to provide information to members with respect to loss control and risk management, no profit or other benefit may be accorded to any member of the organization other than through providing members with insurance coverage below the cost of comparable commercial coverage and through providing members with loss control and risk management information. Only charitable tax-exempt organizations described in section 501(c)(3) may be members of a qualified charitable risk pool.

The Small Business Act further requires that a qualified charitable risk pool: (1) be organized as a nonprofit organization under State law authorizing risk pooling for charitable organizations; (2) be exempt from State income tax; (3) obtain at least $1 million in startup capital from nonmember charitable organizations; (4) be controlled by a board of directors elected by its members; and (5) provide in its organizational documents that members must be tax-exempt charitable organizations at all times, and if a member loses that status it must immediately notify the organization, and that no insurance coverage applies to a member after the date of any final determination that the member no longer qualifies as a tax-exempt charitable organization.

To be entitled to tax-exempt status under section 501(c)(3), a qualified charitable risk pool described in the provision also must satisfy the other requirements of that section (i.e., the private inurement test and the prohibition of political campaign activities and substantial lobbying).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1997, $1 million in 1998 through 2001, $2 million in 2002 through 2004, and $3 million in 2005 and 2006.

5. Treatment of dues paid to agricultural or horticultural organizations (sec. 1115 of the Small Business Act and sec. 512 of the Code)

Present and Prior Law

Tax-exempt organizations generally are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers, but who became "associate" members for the purpose of obtaining health insurance available to members of the organization. See *National League of Postmasters of the United States v. Commissioner*, No. 95-2646 (4th Cir. 1996); *American Postal Workers Union, AFL-CIO v. United States*, 925 F.2d 480 (D.C. Cir. 1991); *National Association of Postal Supervisors v. United States*, 944 F.2d 859 (Fed. Cir. 1991).

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

Reasons for Change

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

Explanation of Provision

Under the Small Business Act, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding $100 to be paid in order to be a member of such organization, then in no event will any portion of such dues be subject

to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount will be indexed for inflation. The term "dues" is defined as "any payment (whether or not designated as dues) which is required to be made in order to be recognized by the organization as a member of the organization." Thus, if a person is recognized as a member of an organization by virtue of having paid annual dues for his or her membership, then any subsequent payments made by that person during the year to purchase another membership in the same organization (covering the same period) will not be within the scope of the provision.

The Congress intended that, if a person makes a single payment that entitles the person to be recognized as a member of the organization for more than twelve months, then such payment may be prorated to determine whether annual dues exceed the $100 cap (as adjusted for inflation).

Effective Date

The provision applies to taxable years beginning after December 31, 1986. Transitional relief also is provided to agricultural or horticultural organizations that had a reasonable basis for not treating membership dues received prior to January 1, 1987, as unrelated business income. In such cases, no portion of such dues will be treated as derived from an unrelated trade or business.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

6. Clarify employment tax status of certain fishermen (sec. 1116(a) of the Small Business Act and secs. 3121(b)(20), 3306(c)(18), 3401(a)(17), and 6050A of the Code)

Present and Prior Law

Under present and prior law, service as a crew member on a fishing vessel generally is excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) taxes if the operating crew of the boat normally consists of fewer than 10 individuals and the individual receives a share of the catch based on the total catch. Under prior law, in order for the exemption to apply the individual could not receive cash remuneration other than proceeds from the sale of the individual's share of the catch. If the crew member received any other cash, e.g., payment for services as an engineer, then the exemption did not apply. Under present and prior law, crew members to which the exemption applies are subject to self-employment taxes.

Under present and prior law, the operator of a boat on which an exempt crew member serves is required to report (1) the identity of the individual performing the exempt services, (2) the individual's and operator's percentage share of the catch, (3) if the individual receives his or her share of the catch in kind, information re-

garding such share (such as weight and type), and (4) if the individual receives a share of the proceeds of the catch, the amount so received.

Reasons for Change

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

Explanation of Provision

The exemption from income tax withholding, FICA, and FUTA taxes for certain crew members is modified to provide that the operating crew of a boat is treated as normally made up of fewer than 10 individuals if the average size of the operating crew on trips made during the preceding 4 calendar quarters consisted of fewer than 10 individuals. In addition, the exemption applies if the crew member receives, in addition to the cash remuneration permitted under prior law (proceeds from the individual's share of the catch), cash remuneration which does not exceed $100 per trip, is contingent on a minimum catch, and is paid solely for additional duties (e.g., as mate, engineer, or cook) for which additional cash remuneration is customary.

The reporting requirement applicable to operators of a boat on which an exempt crew member serves is modified to include information regarding the additional cash remuneration (if any) that the individual receives as permitted under the exemption.

Effective Date

The provision applies to remuneration paid after December 31, 1994. In addition, the provision applies to remuneration paid after December 31, 1984, and before January 1, 1995, unless the payor treated such remuneration when paid as subject to wage withholding and employment taxes.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1996, $10 million in 1997, and less than $500,000 in each of 1998 through 2006.

7. Reporting requirements for purchasers of fish (sec. 1116(b) of the Small Business Act and new sec. 6050Q of the Code)

Present and Prior Law

Under present and prior law, a person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for "rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or deter-

minable gains, profits, or other income" must file an information return with the Internal Revenue Service reporting the amount of such payments, as well as the name, address, and taxpayer identification number of the person to whom such payments were made (Code sec. 6041). A similar statement must also be furnished to the person to whom such payments were made. Treasury regulations provide that payments for "merchandise" are not required to be reported under this provision (Treas. reg. sec. 1.6041-3(d)). Consequently, under prior law, information reporting was generally not required with respect to purchases of fish or other forms of aquatic life. Information reporting is required by a person engaged in a trade or business who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or several related transactions) (Code sec. 6050I).

Reasons for Change

The Congress believed that requiring information reporting would enhance compliance with the internal revenue laws.

Explanation of Provision

The Small Business Act requires persons engaged in the trade or business of purchasing fish for resale who pay more than $600 in cash in a calendar year for fish or other forms of aquatic life from any seller engaged in the trade or business of catching fish to file information reports with the Secretary regarding such purchases. A copy of the report must be provided to the seller.

Effective Date

The provision is effective for purchases made after December 31, 1996.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $5 million in 1998, $9 million in 1999, $10 million in 2000 and 2001, $11 million in 2002 through 2004, and $12 million in 2005 and 2006.

8. Modify rules governing issuance of tax-exempt bonds for first-time farmers (sec. 1117 of the Small Business Act and sec. 147 of the Code)

Present and Prior Law

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

be the principal user of the property and will materially participate in the farming operation in which the property is to be used.

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

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

Under general rules governing issuance of tax-exempt bonds, working capital financing (including purchases from related parties) is precluded.

Reasons for Change

The Congress determined that modifications to the rules governing tax-exempt financing for first-time farmers were appropriate to allow private activity tax-exempt financing for persons desiring to enter that occupation, including entry by younger generations purchasing family farming operations.

Explanation of Provision

The Small Business Act makes two modifications to the rules governing issuance of tax-exempt bonds for first-time farmers. First, the amount of farm land that an individual may own and still be considered a first-time farmer is doubled, from 15 percent of the median farm size in the county where the land is located to 30 percent of the median farm size in that county.

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

A seller is not treated as having a financial interest in the purchaser's farming operation if the seller:

(1) has no more than a 10-percent interest in the capital or profits in a partnership owning or operating the farm;

(2) has no more than a 10-percent stock interest in a corporation owning or operating the farm;

(3) has no more 10-percent of the beneficial interest in a trust owning or operating the farm;

(4) is not a principal user of the farm; or

(5) has no other direct or indirect ownership or use of the farm which has as a principal purpose, the avoidance of this provision.

The Small Business Act further provides that issuers making loans to finance related party sales must provide appropriate notice

to borrowers of these restrictions and of the fact that bond-proceeds may not be re-transferred from sellers to purchasers as part of efforts (e.g., step-transactions) to transfer both property financed with the bond proceeds and the bond proceeds received by the seller. For example, a farmer, who sells his farm to his son who receives tax-exempt financing for the sale, cannot immediately make a gift to the son of the proceeds of the sale.

Effective Date

The provision is effective for financing provided with bonds issued after the date of enactment (after August 20, 1996).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1997, $6 million in 1998, $12 million in 1999, $17 million in 2000, $21 million in 2001, $26 million in 2002, $30 million in 2003, $34 million in 2004, $37 million in 2005, and $40 million in 2006.

9. Clarify treatment of newspaper distributors and carriers as direct sellers (sec. 1118 of the Small Business Act and sec. 3508 of the Code)

Present and Prior Law

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

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

In addition to the common-law test, there are also some persons who are treated by statute as either employees or independent con-

tractors. For example, "direct sellers" are deemed to be independent contractors. A direct seller is a person engaged in the trade or business of selling consumer products (a) in the home or otherwise than in a permanent retail establishment, or (b) to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations for resale in the home otherwise than in a permanent retail establishment, if substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

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

Reasons for Change

The Congress recognized that there have been numerous disputes between newspaper distributors and carriers and the Internal Revenue Service regarding the treatment of newspaper distributors and carriers as direct sellers. The Congress believed that in the majority of these cases the newspaper distributors and carriers should properly be treated as direct sellers. Consequently, in order to avoid further disputes, the Congress wished to clarify the treatment of qualifying newspaper distributors and carriers as direct sellers.

Explanation of Provision

The Small Business Act clarifies the treatment of qualifying newspaper distributors and carriers as direct sellers. Under the Act, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business, such as solicitation of customers or collection of receipts) qualifies as a direct seller, provided the prior-law requirements for direct seller status are satisfied. That is, substantially all the remuneration for the performance of the services must be directly related to sales or other output rather than to the number of hours worked, and the services performed by the person must be performed pursuant to a written contract between such person and the service recipient and such contract must provide that the person will not be treated as an employee for Federal tax purposes. The Small Business Act is intended to apply to newspaper distributors and carriers whether or not they hire others to assist in the delivery of newspapers. The Small Business Act also applies to newspaper distributors and carriers operating under either a buy-sell distribution system (i.e., where the newspaper distributors or carriers purchase the newspapers from the publisher) or an agency distribution system. For

example, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement qualify as direct sellers. The employment status of newspaper distributors and carriers who do not qualify as direct sellers under the Small Business Act continues to be determined under prior-law rules. No inference is intended with respect to the employment status of newspaper distributors and carriers prior to the effective date of the provision. Further, the provision is intended to clarify the worker classification issue for income and employment taxes only. The provision is not intended to have any impact whatsoever on the interpretation or applicability of Federal, State, or local labor laws.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

10. Application of involuntary conversion rules to property damaged as a result of Presidentially declared disasters (sec. 1119 of the Small Business Act and sec. 1033(h) of the Code)

Prior Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period property similar or related in service or use. If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. For this purpose, property used in one trade or business may not have been treated as similar or related in service in use to property used in another trade or business.

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $6 million in 1996, $14 million in 1997, and $10 million a year thereafter.

11. Establish 15-year recovery period for retail motor fuels outlet stores (sec. 1120 of the Small Business Act and sec. 168 of the Code)

Present and Prior Law

Property used in the retail gasoline trade is depreciated under section 168 using a 15-year recovery period and the 150-percent declining balance method. Nonresidential real property (such as a grocery store) is depreciated using a 39-year recovery period and the straight-line method. It was understood that taxpayers generally took the position that convenience stores and other buildings installed at retail motor fuels outlets had a 15-year recovery period. The Internal Revenue Service ("IRS"), in a position described in a recent Coordinated Issues Paper, generally limited the application of the 15-year recovery period to instances where the structure: (1) was 1,400 square feet or less and met certain other requirements or (2) met a 50-percent test. The 50-percent test was met if: (1) 50 percent or more of the gross revenues that were generated from the building were derived from petroleum sales *and* (2) 50 percent or more of the floor space in the building was devoted to petroleum marketing sales. The IRS treated structures not meeting these requirements as nonresidential real property.

Reasons for Changes

The Congress believed that the position taken by the IRS with respect to certain structures installed at motor fuel retail outlets was contrary to the historical treatment of such property. The Congress sought to clarify (and restore) the treatment of such property.

Explanation of Provision

The Small Business Act provides that 15-year property includes any section 1250 property (generally, depreciable real property) that is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet). A retail motor fuels outlet does not include any facility related to petroleum or natural gas

trunk pipelines or to any section 1250 property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products. In addition, the provision provides a 20-year class life for retail motor fuels outlets for purposes of the alternative depreciation system of section 168(g).

The Small Business Act clarifies what types of property qualify as a retail motor fuels outlet. Section 1250 property will so qualify if it meets a 50-percent test. The 50-percent test is met if: (1) 50 percent or more of the gross revenues that are generated from the property are derived from petroleum sales *or* (2) 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. The Congress intended that the determination of whether either prong of this test is met will be made pursuant to the recent Coordinated Issue Paper. Property not meeting the test will not qualify as a retail motor fuels outlet. For property placed in service in taxable years that end after the date of enactment, the determination of whether the property meets the 50-percent test generally will be made in the year the property is placed in service. However, the test may be applied in the subsequent taxable year if the property is placed in service near the end of the taxable year and the use of the property during such short period is not representative of the subsequent use of the property. The Congress intended that, with respect to property placed in service in taxable years that ended before the date of enactment of the provision, the determination of whether the property meets the 50-percent test generally will be made in a manner consistent with the manner in which the 50-percent test of the Coordinated Issues Paper is applied (but by using the disjunctive test intended by the Congress rather than the conjunctive test of the Paper). The Congress also intended that if property initially meets (or fails to meet) the disjunctive 50-percent test but subsequently fails to meet (or meets) such test for more than a temporary period, such failure (or qualification) may be treated as a change in the use of property to which section 168(i)(5) applies.

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

Effective Date

The provision is effective for property placed in service on or after the date of enactment. The taxpayer may elect to apply the provision for any property to which the amendments made by section 201 of the Tax Reform Act of 1986 apply (i.e., property subject to the modified Accelerated Cost Recovery System of sec. 168) and which was placed in service prior to the date of enactment of the Small Business Act. This election shall be made in a manner prescribed by the Secretary of the Treasury. The Secretary of the Treasury may treat such election as a change in the taxpayer's method of accounting for such property and may provide rules similar to those provided in Rev. Proc. 96-31, 1996-20 I.R.B. 11, May 13, 1996. A taxpayer may elect the application of the provision for qualified property placed in service prior to the date of enactment. It is intended that if a taxpayer has already treated qualified property that was placed in service before the date of enactment as 15-

year property, the taxpayer will be deemed to have made the election with respect to such property.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $7 million in 1996, $24 million in 1997, $37 million in 1998, $45 million in 1999, $50 million in 2000, $53 million in 2001, $53 million in 2002, $55 million in 2003, $61 million in 2004, $42 million in 2005, and $25 million in 2006.

12. Treatment of leasehold improvements (sec. 1121 of the Small Business Act and sec. 168 of the Code)

Present and Prior Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[52] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[53] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[54]

Treatment of dispositions of leasehold improvements

A taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a lessee are taken into account to compute gain or loss by the lessee.[55] The proper treatment of the adjusted basis of improvements made by a lessor upon termination of a lease was less clear. Proposed Treasury regulation section 1.168-2(e)(1) provided that the

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

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

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

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

unadjusted basis of a building's structural components must be recovered as a whole. In addition, proposed Treasury regulation sections 1.168-2(l)(1) and 1.168-6(b) provided that "disposition" does not include the retirement of a structural component of real property if there is no disposition of the underlying building.[56] Thus, it appears that it was the position of the Internal Revenue Service that leasehold improvements made by a lessor that constitute structural components of a building were to be continued to be depreciated in the same manner as the underlying real property, even if such improvements were retired at the end of the lease term.[57] Some lessors, on the other hand, may have taken the position that a leasehold improvement was a property separate and distinct from the underlying building and that an abandonment loss under section 165 was allowable at the end of the lease term for the adjusted basis of the property. In addition, lessors may have argued that even if a leasehold improvement constituted a structural component of a building, proposed Treasury regulation section 1.168-2(l)(1) (that seemingly denied the deduction at the end of the lease term) applied only to retirements, but not abandonments or demolitions, of such property.[58] Thus, it appears that some lessors took the position that, at least in certain circumstances, the adjusted basis of leasehold improvements was recovered at the end of the term of the lease to which the improvements relate even if there was no disposition of the underlying building.

Reasons for Change

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

Explanation of Provision

Under the Small Business Act, a lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease.[59] The provision thus con-

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

[57] See, IRS General Information Letter, dated Sept. 17, 1992.

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

[59] The conference report describing this provision mistakenly states that the provision applies to improvements that are irrevocably disposed of or abandoned by the *lessee* (rather than the *lessor*) at the termination of the lease.

forms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

For purposes of applying the provision, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. In addition, the Secretary of the Treasury may provide guidance, as necessary, regarding the determination of when a leasehold improvement is made for a lessee and when such property is irrevocably abandoned or disposed of. The provision does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.[60]

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $12 million in 1996; $22 million in 1997; $19 million in 1998; $16 million in 1999; $13 million in 2000; $11 million in 2001; $7 million in 2002; $4 million in 2003; and $2 million in 2004, and increase Federal budget receipts by $1 million in 2005 and $4 million in 2006.

13. Modifications to section 530 of the Revenue Act of 1978 (sec. 1122 of the Small Business Act and sec. 530 of the Revenue Act of 1978)

Present and Prior Law

In general

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

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Treasury regulations provide that an employer-employee relationship generally exists if the person contracting for

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[60] Under present law, section 280B denies a deduction for any loss sustained on the demolition of any structure.

services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[61] Under the Treasury regulations, it is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined based on all the relevant facts and circumstances.[62] The Internal Revenue Service ("IRS") issued a training guide for field agents that provides current IRS views regarding worker classification issues.[63]

Section 530

In general

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as self employed rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' employment and income tax liabilities (that the employer had failed to withhold and pay over) and the employer's portion of such tax liabilities, although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 ("section 530").[64] That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Section 530 was initially scheduled to terminate at the end of 1979 to give the Congress time to resolve the many complex issues regarding worker classification. It was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. The provision was extended permanently by the Tax Equity and Fiscal Responsibility Act of 1982.[65]

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

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[61] Treas. Reg. sec. 31.3401(c)-(1)(b).

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

[63] The IRS initially issued a draft training guide, "Employee or Independent Contractor?" (Draft, February 28, 1996)(the "IRS Draft Training Guide"). The training guide was finalized during Congressional consideration of the Act, "Employee or Independent Contractor," Department of the Treasury, Internal Revenue Service, Training 3320-102 (7-96) TPDS (the "IRS Final Training Guide").

[64] Public Law 95-600.

[65] Public Law 97-248.

contractor. The legislative history states that section 530 is to be "construed liberally in favor of taxpayers."[66]

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

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

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

Status of worker

Under prior law, there was no statement in the language of section 530 requiring that there first be a determination that a worker was an employee under the common-law test before the relief under section 530 became available. It was the position of the IRS, based on legislative history, that section 530 could only apply after such a determination was made.[67] The IRS did not require the taxpayer to concede or agree to a determination that the worker was an employee for section 530 relief to be available.[68]

Several courts that explicitly considered the question held that section 530 relief was available irrespective of whether there had been an initial determination of worker classification under the common law.[69] Courts in the cases cited in the IRS Final Training Guide in support of the IRS' position did determine worker status before applying section 530.[70] However, it is unclear whether such determination was made because the court believed a threshold determination was required or merely as a natural consequence of the court's disposition of the case (i.e., the taxpayers first argued

[66] H. Rept. 95-1748 (95th Cong., 2d Sess., 5 (1978)). The conference agreement to the Revenue Act of 1978 adopted the provisions of the House bill and therefore incorporates this legislative history.

[67] IRS Final Training Guide, at 3-4.

[68] IRS Final Training Guide, at 3-5. TAM 9443002 (December 3, 1993).

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

[70] IRS Final Training Guide, at 3-6.

that the workers were not employees under the common law test, or in the alternative, section 530 provided relief).[71]

Judicial or administrative precedent safe harbor

Under section 530, reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer is deemed a reasonable basis for treating a worker as an independent contractor. If a taxpayer relies on this safe harbor, the IRS will look to see whether the facts of the judicial precedent or published ruling are sufficiently similar to the taxpayer's facts.[72]

Prior audit safe harbor

Under the prior audit safe harbor under prior law, reasonable reliance was generally found to exist if the IRS failed to raise an employment tax issue on audit, even though the audit was not related to employment tax matters. Under present and prior law, a taxpayer can also rely on a prior audit in which an employment tax issue was raised, but was resolved in favor of the taxpayer. According to the IRS, an "audit" must involve an examination of the taxpayer's books and records; mere inquiries from an IRS service center or a "compliance check" to determine whether a taxpayer has filed all returns does not suffice, unless the IRS asked about the reason for worker classification or examined books and records other than those IRS forms that are required to be filed or maintained.[73] In order to rely on a prior audit, the IRS requires that the taxpayer must have treated the workers at issue as independent contractors during the period covered by the prior audit.[74]

Industry practice safe harbor

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

Under prior law, section 530 did not specify a period of time in order for a practice to be long standing. The IRS Final Training Guide provides that a practice is most clearly long standing if the industry has treated workers as independent contractors since 1978.[75] According to the IRS Final Training Guides, the safe harbor was not met if the industry only recently began to treat workers as independent contractors.[76] One court held that seven years qualified as long standing.[77]

The IRS Final Training Guide recognizes that a taxpayer may use the industry practice safe harbor even if it began business after

[71] See e.g., *Overeen v. U.S.*, 91-2 USTC No. 50, 459 (W.D. Okla. 1991); *Galbraith and Green, Inc. v. U.S.*, 80-2 USTC No. 9,629 (Az. 1980).
[72] See e.g., TAM 9443002 (December 3, 1993); TAM 9330007 (April 28, 1993).
[73] IRS Final Training Guide, at 3-18 to 3-19.
[74] IRS Final Training Guide, at 3-20.
[75] IRS Final Training Guide, at 3-24.
[76] IRS Final Training Guide at 3-24. The IRS Final Training Guide (at 3-24) provides that a practice that has existed for 10 years or more is presumed to be long standing.
[77] *REAG, Inc. v. U.S.*, 801 F.Supp. 494 (W.D. Okla. 1992).

1978.[78] The IRS Final Training Guide provides that if the industry practice changed by the time the taxpayer joined the industry, the taxpayer cannot rely on the former practice. Under prior law, the IRS position with respect to whether a new industry (i.e., one beginning after 1978) could take advantage of the industry practice safe harbor was unclear; the IRS Final Training Guide is silent on this issue.

Under present and prior law, a taxpayer's industry generally consists of businesses competing for the same customers and providing the same or a similar product or service.[79] Further, what constitutes the taxpayer's industry generally is determined by reference to the geographic or metropolitan area in which the taxpayer conducts its business.[80]

Under prior law, neither section 530, nor the legislative history, provided a clear standard as to what constituted a significant segment of a taxpayer's industry. The IRS Final Training Guide provided that the determination would be based on the facts and circumstances.[81] A few courts addressed this issue. In one case, the IRS argued that a significant segment of the industry meant more than 50 percent of the industry.[82] However, that court held that a significant segment was less than a majority of the firms in an industry. Another court stated that a survey showing that 15 out of 84 industry respondents (18 percent) treating workers as independent contractors constituted a significant segment of an industry.[83]

Even if a taxpayer can establish a long-standing recognized practice of a significant segment of the industry, the IRS requires the taxpayer to show that it had knowledge of the practice at the time it began treating workers as independent contractors.[84]

Other reasonable basis

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

Under case law, reliance on the advice of an attorney or an accountant may constitute a reasonable basis for treating a worker as an independent contractor.[85] The IRS agrees with this position, provided there is a showing that the business reasonably believed that the attorney or accountant was familiar with business tax is-

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[78] IRS Final Training Guide, at 3-24. The IRS Final Training Guide also provides that a business may use the industry practice safe harbor even if it began to provide a product or service after 1978.

[79] See *Sanderson III v. U.S.*, 862 F.Supp. 196 (N.D. Ohio 1994)(court held that relevant industry was owner-operated truckers rather than trucking industry as a whole); IRS Draft Training Guide, at 3-23.

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

[81] IRS Final Training Guide, at 3-25.

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

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

[84] TAM 9619001 (January 29, 1996); IRS Final Training Guide, at 3-26.

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

sues and the advice was based on sufficient relevant facts furnished by the business to the attorney or accountant.[86]

Taxpayers generally have argued successfully that reliance on the common-law test can constitute a reasonable basis for purposes of applying section 530.[87] The IRS now concurs with this view.[88]

Reporting consistency

To be entitled to relief under section 530, the taxpayer must not have treated the worker as an employee for any period, and, for periods since 1978, all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. For example, withholding income and employment taxes from a worker's remuneration would not be consistent with treatment as an independent contractor, and the taxpayer must file a Form 1099 (if required) with respect to the worker as opposed to a Form W-2.[89] If a taxpayer does not file the required information return for a period it will not be entitled to section 530 relief for such period.[90] Further, the courts have generally held that since 1978 (or such shorter period as the taxpayer has been in business), Federal tax reporting with respect to the worker (and all similarly situated workers) must have been consistent with independent contractor treatment.[91] The filing of consistent Federal tax returns for only the period of examination will not be sufficient. However, the IRS has taken the position that the fact that a taxpayer changes its treatment of workers from independent contractor status to employee status does not affect the applicability of section 530 for prior periods.[92]

Consistency among workers with substantially similar positions

In order for section 530 to apply, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977. Whether workers are similarly situated is dependent on the facts and circumstances. The IRS Final Training Guide states that a "substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities is substantially similar."[93]

There have been a few court decisions addressing this issue. For example, in *REAG, Inc. v. U.S.*,[94] the court held that the position of appraisers who were owner-officers of the business was not sub-

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[86] IRS Final Training Guide, at 3-29; see also *In re McAtee*, 66 AFTR2d No. 94-667 (Bkrtcy. N.D. Iowa 1990)(taxpayer could not rely on advice of accountant where it is not established accountant had expertise in employment tax matters).

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

[88] The IRS Draft Training Guide, at 3-29, provided that the common law could not be a basis for section 530 relief. This position was reversed in the IRS Final Training Guide, at 3-30.

[89] Rev. Proc. 85-18.

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

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

[92] Rev. Proc. 85-18.

[93] IRS Final Training Guide, at 3-11.

[94] 801 F.Supp. 494 (W.D. Okla. 1992). The IRS has nonacquiesced. IRS Draft Training Guide, at 3-13.

stantially similar to appraisers who were not owners since the owner-officers had managerial responsibilities. By contrast, in *Lowen Corp. v. U.S.*,[95] the court found that all workers engaged in the business of selling real estate signs had substantially similar positions even though some were salaried and had to file daily reports while others were paid by commission and did not have to file such reports.

Burden of proof

Under prior law, the IRS Final Training Guide stated that the burden of proof was on the taxpayer to demonstrate that it had a reasonable basis for treating a worker as an independent contractor.[96] However, in light of the Congressional instruction in the legislative history to construe section 530 liberally,[97] courts appeared to be split as to how stringent a burden to apply.

In *McClellan v. U.S.*,[98] the court held that section 530 requires the "taxpayer to come forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness. . . . [T]his threshold burden is relatively low, and can be met with any reasonable showing. Once the taxpayer has made this prima facie showing, the burden then shifts to the IRS to verify or refute the taxpayer's explanation." By contrast, in *Boles Trucking, Inc., v. U.S.*,[99] the court held that the burden is on the taxpayer to show, based on a preponderance of the evidence, that it had a reasonable basis for treating workers as independent contractors.

Reasons for Change

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

[95] 785 F.Supp. 913 (D. Kan. 1992).

[96] IRS Final Training Guide, at 3-29.

[97] H. Rept. 95-1748 (95th Cong., 2d Sess., 5 (1978)). The conference agreement to the Revenue Act of 1978 adopted the provisions of the House bill and therefore incorporates this legislative history.

[98] 900 F.Supp. 101 (E.D. Mich. 1995). See also *REAG, Inc. V. U.S.*, 801 F.Supp. 494 (W.D. Okla. 1992)(a taxpayer need only show a substantial rational basis for its decision to treat the workers as independent contractors).

[99] 77 F.3d 236 (8th Cir. 1996). See also *Springfield v. U.S.*, 873 F.Supp.1403 (S.D. Cal. 1994)(taxpayer has the burden to show it satisfies the requirements of section 530).

Explanation of Provision

The Small Business Act makes several clarifications of and modifications to section 530.

Determination of employee status

Under the Small Business Act, a worker does not have to otherwise be classified as an employee of the taxpayer in order for section 530 to apply. The provision is intended to reverse the IRS position, as stated in the IRS Final Training Guide, that there first must be a determination that the worker is an employee under the common-law standards before application of section 530.

Prior audit safe harbor

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

IRS notification

The Small Business Act provides that an officer or employee of the IRS must provide the taxpayer with written notice of the provisions of section 530. This notice must be provided at (or before) the commencement of an audit inquiry involving worker classification issues. In many cases, the portion of an audit involving worker classification issues will not arise until after the examination of the taxpayer begins. In such cases, the notice need only be given at the time the worker classification issue is first raised with the taxpayer.[100]

Industry practice safe harbor

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

The Small Business Act also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered long standing. As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of

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[100] The IRS has issued a publication describing the provisions of section 530 that will be used by IRS examiners to satisfy this requirement. IR-96-44 (Oct. 30, 1996).

time may be considered long standing based on the particular facts and circumstances.

In addition, the Small Business Act clarifies that an industry practice will not fail to be treated as long standing merely because such practice began after 1978. Consequently, the provision clarifies that new industries can take advantage of section 530.

Definition of substantially similar position

The Small Business Act provides that, in determining whether a worker holds a substantially similar position to another worker for purposes of section 530, the relationship of the parties, including the degree of supervision and control of the worker by the taxpayer, must be one of the factors taken into account.

Change in worker status

The Small Business Act adopts the IRS position contained in Rev. Proc. 85-18 that the fact that a taxpayer changes its treatment of workers from independent contractor status to employee status for employment tax purposes does not affect the applicability of section 530 for prior periods.

Burden of proof

The Small Business Act modifies the burden of proof in section 530 cases by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of section 530,[101] the burden of proof shifts to the IRS with respect to such treatment.[102] In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker as an independent contractor under section 530. It is intended that a request by the IRS will not be treated as reasonable if complying with the request would (1) be impracticable given the particular circumstances and the relative costs involved or (2) if the request does not relate to the particular basis on which the taxpayer relied in establishing its reasonable basis. The shift in the burden of proof does not apply for purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor, but does apply to all other aspects of section 530. So, for example, provided the taxpayer establishes its prima facie case and fully cooperates with the IRS' reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of section 530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial or administrative precedent, prior audit, or long-standing industry practice safe harbors, whether the taxpayer filed all Federal tax returns on a basis consistent with treating the worker as an independent contractor, and whether the taxpayer treated any worker holding a substantially

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

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

similar position as an employee. No inference is intended with respect to the application of the burden of proof in section 530 cases prior to the effective date of this provision.

Effective Date

The provisions generally apply to periods after December 31, 1996. The provision regarding the burden of proof applies to disputes with respect to periods after December 31, 1996.

Revenue Effect

The provision relating to the definition of a substantially similar position is estimated to have a negligible effect on Federal fiscal year budget receipts. The provision providing that a taxpayer's reclassification of workers does not affect the applicability of section 530 for prior periods is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in each of the years 1996 through 2006. The remainder of the provisions are estimated to reduce Federal fiscal year budget receipts by less than $500,000 in each of the years 1997 through 2001, and by $1 million in each of the years 2002 through 2006.

14. Employee housing for certain medical research institutions (sec. 1123 of the Small Business Act and sec. 119(d) of the Code)

Present and Prior Law

Under Code section 119(d), employees of an educational institution described in Code section 170(b)(1)(A)(ii) do not have to include in income the fair market value of campus housing as long as the rent is at least five percent of the appraised value of the housing. If the rent is less than the five-percent safe harbor, there is inclusion into income to the extent that the rent that was charged falls short of the lesser of five percent of the appraised value or the average of rents paid by individuals (other than employees or students of the educational institution) for similar lodging provided by the institution.

Reasons for Change

The Congress believed that it was appropriate to expand present-law section 119(d) to apply to certain other educational institutions.

Explanation of Provision

The Small Business Act treats as educational institutions for purposes of Code section 119(d) certain medical research institutions (referred to as academic health centers) that have as one of their principal purposes or functions the providing and teaching of basic and clinical medical science and research with the entity's own faculty (regardless of the fact that the students may formally matriculate at another educational institution).

The Small Business Act also treats as educational institutions for purposes of Code section 119(d) certain entities (so-called university systems) organized under State law and composed of public

educational institutions described in Code section 170(b)(1)(A)(ii). The Congress intended that, for purposes of the present-law requirement of Code section 119(d)(3)(A) that the employee housing be provided on (or in the proximity of) a campus of the employer, a campus of one of the component educational institutions of a university system should be considered to be a campus of the university system.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year.

B. Extension of Certain Expiring Provisions

1. Work opportunity tax credit (sec. 1201 of the Small Business Act and sec. 51 of the Code)

Prior Law

General rules

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

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

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

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

Certification of members of targeted groups

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

the employer. The "designated local agency" was the State employment security agency.

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

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

Targeted groups eligible for the credit

The nine groups eligible for the credit were either recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled individuals.

(1) Vocational rehabilitation referrals

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

(2) Economically disadvantaged youths

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

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

(3) Economically disadvantaged Vietnam-era veterans

The third targeted group was Vietnam-era veterans certified by the designated local employment agency as members of economi-

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

(4) SSI recipients

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

(5) General assistance recipients

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

(6) Economically disadvantaged former convicts

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

(7) Economically disadvantaged cooperative education students

The seventh targeted group was youths who (a) actively participated in qualified cooperative education programs, (b) had attained

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

For this purpose, a qualified school was (1) a specialized high school used exclusively or principally for the provision of vocational education to individuals who were available for study in preparation for entering the labor market, (2) the department of a high school used exclusively or principally for providing vocational education to individuals who were available for study in preparation for entering the labor market, or (3) a technical or vocational school used exclusively or principally for the provision of vocational education to individuals who had completed or left high school and who were available for study in preparation for entering the labor market. In order for a nonpublic school to be a qualified school, it must have been exempt from income tax under section 501(a) of the Code.

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

(8) AFDC recipients

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

(9) Economically disadvantaged summer youth employees

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

Definition of wages

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

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

Other rules

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

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

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

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

No credit was allowed for wages paid unless the eligible individual was either (1) employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth

employees) or (2) had completed at least 120 hours (20 hours for summer youth) of services performed for the employer.

Reasons for Change

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

Explanation of Provision

General rules

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

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

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

Certification of members of targeted groups

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

individual that forms the basis of the employer's belief that the individual is a member of a targeted group.

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

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

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon

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

(3) High-risk-youth

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

(4) Vocational rehabilitation referral

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

(5) Qualified summer youth employee

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

(6) Qualified Veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

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

(7) Families receiving Food Stamps

An eligible recipient is an individual aged 18 but not 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken

into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Definition of wages and other rules

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

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

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

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

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

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

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Effective Date

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

Revenue Effect

The provision is estimated to decrease fiscal year Federal budget receipts by $116 million in 1997, $141 million in 1998, $82 million in 1999, $32 million in 2000, $12 million in 2001, and $2 million in 2002.

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

Prior Law

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

Reasons for Change

The exclusion for employer-provided educational assistance was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the Tax Reform Act of 1986 (through 1987), by the Technical and Miscellaneous Revenue Act of 1988 (through 1988), by the Omnibus Budget Reconciliation Act of 1989 (through September 30, 1990), by the Omnibus Budget Reconciliation Act of 1990 (through 1991), by the Tax Extension Act of 1991 (through June 30, 1992), and by the Omnibus Budget Reconciliation Act of 1993 (through December 31, 1994). Public Law 98-611 adopted a $5,000 annual limit on the exclusion; this limit was subsequently raised to $5,250 in the Tax Reform Act of 1986. The Technical and Miscellaneous Revenue Act of 1988 made the exclusion inapplicable to graduate-level courses. The restriction on graduate-level courses was repealed by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990.

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

Explanation of Provision

The Small Business Act extends the exclusion for employer-provided educational assistance for taxable years beginning after December 31, 1994, and before June 1, 1997. In the case of taxable years beginning in 1997, the Small Business Act provides that the exclusion expires with respect to courses beginning after June 30, 1997. The Statement of Managers indicates the intent of the Congress that the exclusion expire with respect to courses beginning after May 31, 1997.[103] The exclusion does not apply to graduate level courses beginning after June 30, 1996. Thus, the exclusion applies to graduate courses in 1995, and in 1996 with respect to courses beginning before July 1, 1996. Graduate courses are defined as any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, marketing or other advanced academic or professional degree.

To the extent employers have previously filed Forms W-2 reporting the amount of educational assistance provided as taxable wages, present Treasury regulations would require the employer to file Forms W-2c (i.e., corrected Forms W-2) with the Internal Revenue Service.[104] It is intended that employers would also be required to provide copies of Form W-2c to affected employees.

The Secretary is directed to establish expedited procedures for the refund of any overpayment of taxes paid on excludable educational assistance provided in 1995 and 1996, including procedures for waiving the requirement that an employer obtain an employee's signature if the employer demonstrates to the satisfaction of the Secretary that any refund collected by the employer on behalf of the employee will be paid to the employee.[105]

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

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1994, and before June 1, 1997, with respect to courses beginning before June 1, 1997,[106] and the restriction of the exclusion to undergraduate education is effective for courses beginning after June 30, 1996. As long as the courses begin before the applicable date, the exclusion applies even if the employer pays for the courses (or reimburses the employee) after such date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $68 million in 1996, $934 million in 1997, and $103 million in 1998.

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[103] A technical correction may be necessary so that the statute reflects this intent.

[104] Treasury regulation section 31.6051-1(c).

[105] See IRS News Release, IR-96-36 (August 23, 1996).

[106] See discussion of statutory expiration date in "Explanation of Provision" and in footnote 103.

3. Permanent extension of FUTA exemption for alien agricultural workers (sec. 1203 of the Small Business Act and sec. 3306 of the Code)

Prior Law

Generally, the Federal Unemployment Tax ("FUTA") is imposed on farm operators who (1) employ 10 or more agricultural workers for some portion of each of 20 different days, each day being in a different calendar week or (2) have a quarterly payroll for agricultural services of at least $20,000. An exclusion from FUTA was provided, however, for labor performed by an alien admitted to the United States to perform agricultural labor under section 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act. This exclusion was effective for labor performed before January 1, 1995.

Reasons for Change

The Congress believed that the FUTA exemption is appropriate in light of the ineligibility of those workers for FUTA benefits. Further, a permanent extension will provide certainty to taxpayers, ease tax administration, and obviate the need for further short-term extensions.

Explanation of Provision

The Small Business Act permanently extends the FUTA exemption for alien agricultural workers.

Effective Date

The provision is effective for labor performed on or after January 1, 1995.

Revenue Effect

The provision is estimated to decrease fiscal year Federal budget receipts by $5 million in 1996 and $3 million in every year thereafter.

4. Research and experimentation tax credit (sec. 1204 of the Small Business Act and sec. 41 of the Code)

Prior Law

General rule

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

A 20-percent research tax credit also applied to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) *over* (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to uni-

versities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[107]

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

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

Eligible expenditures

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

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but

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

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

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

Relation to deduction

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

Reasons for Change

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

Explanation of Provision

The Small Business Act extends the research tax credit (including the university basic research credit) for 11 months—i.e., for the period July 1, 1996, through May 31, 1997 (with a special rule for taxpayers who elect the alternative incremental research credit regime, as described below).

The Small Business Act also expands the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.[108]

In addition, the Small Business Act allows taxpayers to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury. If a taxpayer elects the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during the first 11 months of such taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit.[109]

The Small Business Act also provides for a special rule for payments made to certain nonprofit research consortia. Under this special rule, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the present-law section 41(b)(3) rule governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified re-

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

[109] In the event that the research tax credit is not subsequently extended by Congress, a technical correction to the Small Business Act will be needed to carry out congressional intent underlying the Act's 11-month extension of the research tax credit. Specifically, a technical correction is needed so that, if a taxpayer claims the regular credit with respect to any qualified research expenses paid or incurred on or after July 1, 1996, and the taxpayer later switches over to the alternative incremental credit regime, then such a taxpayer may treat (under the Small Business Act) no more than 11 total month's worth of expenses as qualified research expenses for purposes of computing credit amounts under both the regular and alternative credit regimes.

search is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Effective Date

Extension of the research tax credit is effective for expenditures paid or incurred during the period July 1, 1996, through May 31, 1997 (with a special rule for taxpayers who elect the alternative incremental research credit regime). The modification to the definition of "start-up firms" is effective for taxable years ending after June 30, 1996. Taxpayers may elect the alternative research credit regime (with lower fixed-base percentages and lower credit rates) for taxable years beginning after June 30, 1996, and before July 1, 1997, and the credit is available with respect to all qualified research expenses incurred during the first 11 months of such taxable year. The rule that treats 75 percent of qualified research consortium payments as qualified research expenses is effective for taxable years beginning after June 30, 1996.

In addition, the Small Business Act provides that research credit amounts earned under the Act may not be taken into account in computing estimated tax payments required to be paid for a taxable year beginning in 1997.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $101 million in 1996, $331 million in 1997, $872 million in 1998, $208 million in 1999, $148 million in 2000, $77 million in 2001, and $17 million in 2002.

5. Orphan drug tax credit (sec. 1205 of the Small Business Act and secs. 28 and 39 and new sec. 45C of the Code)

Prior Law

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

Under prior law, the orphan drug tax credit could be claimed by a taxpayer only to the extent that its regular tax liability for the year the credit was earned exceeded its tentative minimum tax for that year, after regular tax was reduced by nonrefundable personal

credits and the foreign tax credit.[110] Unused credits could not be carried back or carried forward to reduce taxes in other years.

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

Reasons for Change

The Congress believed that it is appropriate to reinstate the orphan drug tax credit.

Explanation of Provision

The Small Business Act extends the orphan drug tax credit for 11 months—i.e., for the period July 1, 1996, through May 31, 1997.

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

Effective Date

The provision applies to qualified clinical testing expenses paid or incurred during the period July 1, 1996, through May 31, 1997. The provision allowing for the carry back and carry forward of unused credits is effective for taxable years ending after June 30, 1996. No portion of the unused business credit that is attributable to the orphan drug credit may be carried back under section 39 to a taxable year ending before July 1, 1996.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $6 million in 1996, $16 million in 1997, $1 million in each year from 1998 through 2001, and less than $500,000 in each year from 2002 through 2006.

6. Contributions of stock to private foundations (sec. 1206 of the Small Business Act and sec. 170(e)(5) of the Code)

Present and Prior Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[111] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[112]

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

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

[112] As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers were allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to January 1, 1995. Qualified appreciated stock was defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applied only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual was treated as making all contributions that were made by any member of the individual's family. This special rule contained in section 170(e)(5) expired after December 31, 1994.

Reasons for Change

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

Explanation of Provision

The Small Business Act extends the special rule contained in section 170(e)(5) for 11 months—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.[113]

Effective Date

The provision is effective for contributions of qualified appreciated stock to private foundations made during the period July 1, 1996, through May 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $14 million in 1996, $104 million in 1997, $10 million in 1998, and $4 million in 1999.

7. Tax credit for producing fuel from a nonconventional source (sec. 1207 of the Small Business Act and sec. 29 of the Code)

Present and Prior Law

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to

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property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

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

$3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

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

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

Reasons for Change

The Congress believed that a short-term extension of the section 29 credit was appropriate to allow projects in negotiation or under development at the time the Small Business Act was enacted to be placed in service in a more orderly manner than was possible under the prior-law scheduled expiration.

Explanation of Provision

The binding contract date for facilities producing synthetic fuels from coal and gas from biomass is extended through December 31, 1996, and the placed in service date is extended for eighteen months. The prior-law sunset on production qualifying for the credit is not changed. Therefore under the Act, synthetic fuels from coal and gas from biomass produced from a facility placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997, will be eligible for the tax credit if produced before January 1, 2008.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1997, $34 million in 1998, $60 million in 1999, $69 million in 2000, $65 million in 2001, $57 million in 2002, $55 million in 2003, $56 million in 2004, $58 million in 2005, and $59 million in 2006.

8. Suspend imposition of diesel fuel tax on recreational motorboats (sec. 1208 of the Small Business Act and sec. 6427 of the Code)

Present and Prior Law

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

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

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

Reasons for Change

The Congress understood that market conditions in the marine industry have produced shortages of diesel fuel for recreational boat use in some areas. This is reported to have occurred because some marinas primarily serve commercial vessels that burn nontaxable, dyed diesel fuel, and have resisted installing supplemental fuel tanks for the taxable, undyed diesel fuel required for recreational boats. The Congress believed, therefore, that a temporary suspension of this tax is appropriate to allow review of possible alternative collection regimes, and to allow marinas additional time in which to adapt to the requirements of the tax, if satisfactory alternatives are not found.

Explanation of Provision

No tax is imposed on diesel fuel used in recreational motorboats during the period beginning seven days after enactment (August 27, 1996) through December 31, 1997.

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

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1996, $34 million in 1997, and $9 million in 1998.

C. Provisions Relating to S Corporations

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

Present and Prior Law

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

Reasons for Change

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

Explanation of Provision

The Small Business Act increases the maximum number of shareholders from 35 to 75.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 1997, $14 million in 1998, $16 million in 1999, $20 million in 2000, $22 million in 2001, $25 million in 2002, $28 million in 2003, $31 million in 2004, $35 million in 2005, and $39 million in 2006.

2. Electing small business trusts (sec. 1302 of the Small Business Act and sec. 1361 of the Code)

Present and Prior Law

Under prior law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" could not be shareholders in an S corporation. A "qualified subchapter S trust" is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus

distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary's income interest must terminate at the earlier of the beneficiary's death or the termination of the trust, and (4) if the trust terminates during the beneficiary's life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Reasons for Change

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

Explanation of Provision

In general

The Small Business Act allows stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders,[114] except that charitable organizations may hold contingent remainder interests.[115] No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

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

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the 75-shareholder limitation (or if there are no potential current beneficiaries, the trust will be treated as the shareholder). If a potential current beneficiary (or his or her spouse) is a direct shareholder in the S corporation, such person will not be counted twice for purposes of the 75-shareholder limitation. A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition is not treated as a potential current beneficiary.

[114] Thus, a nonresident alien individual may not be a beneficiary.

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

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A qualified subchapter S trust with respect to which an election is in effect[116] or an exempt trust[117] is not eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. This income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries' income. No item relating to the S corporation stock may be apportioned to any beneficiary. Otherwise allowable capital losses are allowed only to the extent of capital gains. The tax liability of the trust that relates to items of income, deduction, and loss attributable to the S corporation stock may be reduced by tax credits that are attributable to the S corporation stock.

In computing the trust's income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than those attributed to the S corporation stock.

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

Treatment of remainder of items held by trust

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

Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S

[116] If a trust meets the requirements of both section 1361(d)(3) as a qualified subchapter S trust and section 1361(e)(A)(i) and (ii) as an electing small business trust, it is expected that the trust must make an election designating which type of trust it intends to be. The Department of Treasury is encouraged to promulgate expedited procedures for existing qualified subchapter S trusts that wish to become electing small business trusts to revoke their former election and make the new election.

[117] For this purpose, a trust described in section 664 will be considered to be an exempt trust, even if such trust loses its tax exemption for a taxable year pursuant to section 664(c). A technical correction may be necessary to clarify this result.

corporation items for its final year. The Small Business Act makes a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million a year from 1997 through 2003 and $3 million a year thereafter.

3. Expansion of post-death qualification for certain trusts (sec. 1303 of the Small Business Act and sec. 1361 of the Code)

Prior Law

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million a year.

4. Financial institutions permitted to hold safe harbor debt (sec. 1304 of the Small Business Act and sec. 1361 of the Code)

Present and Prior Law

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

Reasons for Change

The Congress believed that bona fide debt that is held by a financial institution should be able to satisfy the "straight debt" safe harbor.

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 a year.

5. Rules relating to inadvertent terminations and invalid elections (sec. 1305 of the Small Business Act and sec. 1362 of the Code)

Present and Prior Law

If the Internal Revenue Service ("IRS") determines that a corporation's subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Prior law did not grant the IRS the ability to waive the effect of an inadvertent invalid subchapter S election.

A small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. Under prior law, the IRS could not validate a late election.

Reasons for Change

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

Explanation of Provision

Under the Small Business Act, the authority of the IRS to waive the effect of an inadvertent termination is extended to allow the IRS to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding trusts), or both. The provision also allows the IRS to treat a late subchapter S election as timely where the IRS determines that there was reasonable cause for the failure to make the election timely. The IRS may exercise this authority in cases where the taxpayer never filed an election. It is intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied under prior law to inadvertent subchapter S terminations and other late or invalid elections under present law. In addition, it is intended that in exercising its authority under the provision, the IRS may consider relevant information provided by any affected shareholder (including a person who became a shareholder in a subsequent year) before determining the validity of a subchapter S election for the taxable year in question.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.[118]

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 a year.

6. Agreement to terminate year (sec. 1306 of the Small Business Act and sec. 1377 of the Code)

Present and Prior Law

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

Reasons for Change

The Congress believed that the election to close the books of an S corporation did not need the consent of shareholders whose tax liability is unaffected by the election.

[118] This is the effective date of the present-law provision regarding inadvertent terminations.

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated have a negligible effect on Federal fiscal year budget receipts.

7. Expansion of post-termination transition period (sec. 1307 of the Small Business Act and secs. 1377 and 6037 of the Code)

Present and Prior Law

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

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

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

Reasons for Change

The Congress believed that the current scope of the "post-termination transition period" was insufficient under prior law. In addition, the Congress believed that the TEFRA audit procedures should be inapplicable to entities with a limited number of owners.

Explanation of Provision

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

In addition, the Small Business Act repeals the TEFRA audit provisions applicable to S corporations and provides other rules to require consistency between the returns of the S corporation and its shareholders.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 a year.

8. S corporations permitted to hold subsidiaries (sec. 1308 of the Small Business Act and secs. 1361 and 1362 of the Code)

Prior Law

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

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

Reasons for Change

The Congress understood that there were situations where taxpayers wished to separate different trades or businesses in different corporate entities. The Congress believed that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidiary arrangements as well as brother-sister arrangements.

Explanation of Provision

C corporation subsidiaries

An S corporation is allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C cor-

porations. An S corporation is not allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake are not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

S corporation subsidiaries

In addition, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary is held by its S corporation parent and (2) the parent elects to treat the subsidiary as a qualified subchapter S subsidiary.[119] For this purpose, the term "qualified subchapter S subsidiary" is intended to include a subsidiary, the stock of which is held by a qualified subchapter S subsidiary (i.e., the election is available to chains of qualified corporations as well as brother-sister subsidiaries of an S corporation).[120] The election need not be made for all subsidiaries eligible for treatment as qualified subchapter S subsidiaries.[121]

If a subsidiary ceases to be a qualified subchapter S subsidiary (either because the subsidiary fails to qualify or the parent revokes the election) another such election (or a subchapter S election) may not be made for the subsidiary by the parent (or its shareholders) for five years without the consent of the Secretary of the Treasury. It is expected that the Secretary will provide waivers of the five-year rule in appropriate instances. For example, if the stock of a qualified subchapter S subsidiary is distributed to the individual shareholders of the subsidiary's parent, the subsidiary will no longer be a qualified subchapter S subsidiary and would be subject to the five-year rule. If the parent corporation retains its subchapter S election and the Secretary determines that the distribution was not made for purposes of tax avoidance, it would seem appropriate for the Secretary to waive the five-year rule.

Under the election, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, loss, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction,

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[119] The election to treat a subsidiary as a qualified subchapter S subsidiary and the revocation of an election shall be made pursuant to procedures established by the Secretary of the Treasury.

[120] However, a break in the chain of elections will disqualify lower-tier subsidiaries for treatment as qualified subchapter S subsidiaries. For example, assume an individual owns 100 percent of the stock of Corporation A, which owns 100 percent of the stock of Corporation B, which, in turn, owns 100 percent of the stock of Corporation C. In order for Corporation C to be eligible to be treated as a qualified subchapter S subsidiary, a subchapter S election must in effect for Corporation A and a qualified subchapter S subsidiary election must be in effect for Corporation B.

[121] Thus, in the case of the A-B-C chain of corporations described in the footnote above, a subchapter S election may be made for Corporation A, and a qualified subchapter S subsidiary election may be made for Corporation B, but a qualified subchapter S subsidiary election need not be made for Corporation C.

loss, and credit of the parent S corporation.[122] Thus, transactions between the S corporation parent and qualified subchapter S subsidiary are not taken into account and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, etc.) are considered to be items of the parent. In addition, if a subsidiary ceases to be a qualified subchapter S subsidiary (e.g., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.[123]

Under the Small Business Act, if an election is made to treat an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation) as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective.[124] The built-in gains tax under section 1374 and the LIFO recapture tax under section 1363(d) may apply where the subsidiary was previously a C corporation. Where the stock of the subsidiary was acquired by the S corporation in a qualified stock purchase, an election under section 338 with respect to the subsidiary may be made.

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

Effective Date

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

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[122] For this purpose, a technical correction may be necessary to allow Treasury regulations to treat a qualified subchapter S subsidiary as a separate corporation with its own assets, liabilities and items of income, deduction, loss, and credit for certain Federal income tax purposes. For example, assume a parent S corporation wholly owns stock in a bank (as defined in section 581) and the parent S corporation is not a bank. Treasury regulations may provide that an election to treat the subsidiary as a qualified subchapter S subsidiary would not change the status of either the parent or the subsidiary as a bank or a nonbank for purposes of selected provisions of the Internal Revenue Code applicable only to banks.

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

[124] As described in a footnote above, a technical correction may be necessary to allow Treasury regulations to treat a qualified subchapter S subsidiary as a separate corporation with its own assets, liabilities and items of income, deduction, loss, and credit for certain Federal income tax purposes. Such regulations may provide, in appropriate cases, exceptions to the effects of a deemed section 332 liquidation of a subsidiary upon its election as a qualified subchapter S subsidiary.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 1997, $9 million in 1998, $11 million in 1999, $13 million in 2000, $15 million in 2001, $17 million in 2002, $20 million in 2003, $23 million in 2004, $26 million in 2005, and $29 million in 2006.

9. Treatment of distributions during loss years (sec. 1309 of the Small Business Act and secs. 1366 and 1368 of the Code)

Present and Prior Law

The amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of property.

Income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. Under prior law, the adjustments to basis for items of both income and loss for any taxable year applied before the adjustment for distributions applied.[125]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. However, under the partnership rules (unlike the prior-law S corporation rules), for any taxable year, a partner's basis was first increased by items of income, then decreased by distributions, and finally was decreased by losses for that year.[126]

In addition, if the S corporation has accumulated earnings and profits,[127] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

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

[126] Treas. Reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

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

Reasons for Change

The Congress believed that the rules regarding the treatment of distributions by S corporations during loss years should be the same as the rules applicable to partnerships.

Explanation of Provision

The Small Business Act provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The Small Business Act also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1998, is $1,000 and X holds no debt of A. During 1998, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the provision, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1998, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the provision, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1999, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing

X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1999, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 a year.

10. Treatment of S corporations under subchapter C (sec. 1310 of the Small Business Act and sec. 1371 of the Code)

Present and Prior Law

Present and prior law contain several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, under prior law, an S corporation in its capacity as a shareholder of another corporation was treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). In 1988, the IRS took the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[128] In 1992, the IRS reversed its position, stating that the prior ruling was incorrect.[129]

Reasons for Change

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

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[128] Private letter ruling 8818049 (Feb. 10, 1988).
[129] Private letter ruling 9245004 (July 28, 1992).

Explanation of Provision

The Small Business Act repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million a year.

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

Present and Prior Law

The accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder was later required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Reasons for Change

The Congress believed that the existence of pre-1983 earnings and profits of an S corporation unnecessarily complicates corporate record keeping and constitutes a potential trap for the unwary.

Explanation of Provision

The Small Business Act provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits are solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million a year.

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

Present and Prior Law

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

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million a year.

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

Present and Prior Law

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to such person (sec. 691(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as a "stepped-up basis." Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although an S corporation and its shareholders generally are taxed in a manner similar to the taxation of a partnership and its partners, no comparable regulation provided a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

Reasons for Change

The Congress believed that the present-law treatment of IRD items of an S corporation is unclear and that the treatment of such

items should be similar to the treatment of identical items held by a partnership.

Explanation of Provision

The Small Business Act provides that a person acquiring stock in an S corporation from a decedent will treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock in an S corporation acquired from a decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $1 million a year.

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

Prior Law

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

Reasons for Change

The Congress believed that rules generally applicable to individuals should be applicable to S corporations.

Explanation of Provision

The Small Business Act allows the present-law capital gains presumption of section 1237 in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships will apply to S corporations (Treas. reg. sec. 1.1237-1(b)(3)).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million a year in 1997 and 1998, and $2 million a year thereafter.

15. Certain financial institutions as eligible corporations (sec. 1315 of the Small Business Act and sec. 1361 of the Code)

Present and Prior Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An "ineligible corporation" meant any corporation which was a member of an affiliated group, certain depository financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Reasons for Change

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

Explanation of Provision

A bank (as defined in sec. 581) is allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts. Thus, a large bank (as defined by sec. 585(c)(2)) that meets all the subchapter S eligibility requirements may elect to be treated as an S corporation. An otherwise qualified small bank may elect to be treated as an S corporation if it uses the specific charge-off method of section 166 to account for its bad debts. It is intended that income earned by a bank in the ordinary course of its banking business will not be treated as passive investment income for purposes of sections 1362 and 1375.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1997, $3 million in 1998, $5 million in 1999, $6 million in 2000, $8 million in 2001, $10 million in 2002, $12 million in 2003, $14 million in 2004, $15 million in 2005, and $16 million in 2006.

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

Present and Prior Law

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

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

Reasons for Change

The Congress believed that the present-law prohibition of certain tax-exempt organizations being S corporation shareholders may have inhibited employee ownership of closely-held businesses, frustrated estate planning, discouraged charitable giving, and restricted sources of capital for closely-held businesses. The Congress sought to lift these barriers by allowing certain tax-exempt organizations to be shareholders in S corporations. However, the provisions of subchapter S were enacted in 1958 and substantially modified in 1982 on the premise that all income of the S corporation (including all gains on the sale of the stock) would be subject to a shareholder-level income tax. This underlying premise allows the rules governing S corporations to be relatively simple (in contrast, for example, to the partnership rules of subchapter K) because of the lack of concern about "transferring" income to non-taxpaying persons. Consistent with this underlying premise of subchapter S, the provision treats all the income flowing through to a tax-exempt shareholder, and gains and losses from the disposition of the stock, as unrelated business taxable income.

Explanation of Provision

Tax-exempt organizations described in Code sections 401(a) and 501(c)(3) ("qualified tax-exempt shareholders") are allowed to be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder. An individual retirement account is not a qualified tax-exempt shareholder.

Items of income or loss of an S corporation will flow-through to qualified tax-exempt shareholders as UBTI, regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through to the qualified tax-exempt shareholders

as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBTI. A distribution of stock to a qualified plan participant or beneficiary will be considered to be a taxable disposition.

If a qualified tax-exempt shareholder acquired, by purchase, stock in an S corporation (whether such stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution with respect to such stock (i.e., a distribution of subchapter C earnings and profits), except as provided in regulations, the shareholder must reduce its basis in the stock by the amount of the dividend. Regulations may provide that the basis reduction would apply only to the extent the dividend is deemed to be allocable to subchapter C earnings and profits that accrued on or before the date of acquisition.

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million in 1998, $9 million in 1999, $11 million in 2000, $13 million in 2001, $15 million in 2002, $17 million in 2003, $19 million in 2004, $21 million in 2005, and $23 million in 2006.

17. Reelection of subchapter S status (sec. 1317(b) of the Small Business Act and sec. 1362 of the Code)

Present and Prior Law

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

Reasons for Change

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

Explanation of Provision

For purposes of the five-year rule, any termination of subchapter S status in effect in a taxable year beginning before January 1, 1997, is not taken into account. Thus, a small business corporation

may make an election to be an S corporation after the date of enactment without regard to any termination that may have occurred in a taxable year beginning before January 1, 1997. This waiver of the five-year rule applies to terminations that occurred before date of enactment for re-elections after the date of enactment, as well as terminations that occur in the period after the date of enactment but before taxable years beginning after December 31, 1996.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $5 million a year. In addition, the cumulative interaction of various subchapter S provisions described above is estimated to reduce Federal fiscal year budget receipts by an additional $3 million in 1997, $26 million in 1998, $32 million in 1999, $37 million in 2000, $38 million in 2001, $39 million in 2002, $40 million in 2003, $40 million in 2004, $40 million in 2005, and $40 million in 2006.

II. PENSION SIMPLIFICATION PROVISIONS

A. Simplified Distribution Rules (secs. 1401-1404 of the Small Business Act and secs. 72(d), 101(b), 401(a)(9), and 402(d) of the Code)

Present and Prior Law

In general

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

Lump-sum distributions

Under prior law, lump-sum distributions from qualified plans and qualified annuity plans were eligible for special 5-year forward averaging. In general, a lump-sum distribution was a distribution within one taxable year of the balance to the credit of an employee that became payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-1/2, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. Lump-sum treatment was not available for distributions from a tax-sheltered annuity.

A taxpayer was permitted to make an election with respect to a lump-sum distribution received on or after the employee attained age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution was made. In general, this election allowed the taxpayer to pay a separate tax on the lump-sum distribution that approximated the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election was made, the taxpayer was entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after age 59-1/2 could be made with respect to any employee.

Special transition rules adopted in the Tax Reform Act of 1986 were available with respect to an employee who attained age 50 before January 1, 1986. Under these rules, an individual, trust, or estate could elect to use 5-year forward income averaging (using present-law tax rates) or 10-year forward income averaging (using the tax rates in effect prior to the Tax Reform Act of 1986) with regard to a single lump-sum distribution, without regard to whether the employee had attained age 59-1/2. In addition, an individual, trust, or estate receiving a lump-sum distribution with respect to

such employee could elect to retain the capital gains character of the pre-1974 portion of the lump-sum distribution (using a tax rate of 20 percent).

$5,000 exclusion for employer-provided death benefits

Under prior law, the beneficiary or estate of a deceased employee generally could exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

Under present and prior law, amounts received as an annuity under a qualified plan generally are includible in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis). Under prior law, a pro-rata basis recovery rule generally applied, so that the portion of any annuity payment that represented nontaxable return of basis was determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity.

Under a simplified alternative method provided by the Internal Revenue Service ("IRS") (Notice 88-118), the taxable portion of qualifying annuity payments was determined under a simplified exclusion ratio method.

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

Required distributions

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

Under prior law, a qualified plan was required to provide that the entire interest of each participant would be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date was generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of (1), such April 1, or (2), the April 1 of the year following the year in which the participant retired.

Reasons for Change

In almost all cases, the responsibility for determining the tax liability associated with a distribution from a qualified plan, tax-sheltered annuity, or IRA rests with the individual receiving the distribution. Under prior law, this task could be burdensome. Among other things, the taxpayer had to consider (1) whether special tax rules applied that reduced the tax that otherwise would be paid, (2) the amount of the taxpayer's basis in the plan, annuity, or IRA and the rate at which such basis was to be recovered, and (3) whether or not a portion of the distribution was excludable from income as a death benefit.

The number of special rules for taxing pension distributions made it difficult for taxpayers to determine which method was best

for them and also increased the likelihood of error. In addition, the specifics of each of the rules created complexity. For example, the prior-law rules for determining the rate at which a participant's basis in a qualified plan was recovered often entail calculations that the average participant has difficulty performing. These rules required a fairly precise estimate of the period over which benefits are expected to be paid. The IRS publication on taxation of pension distributions (Publication 939) contains over 60 pages of actuarial tables used to determine total expected payments.

The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. Liberalization of the rollover rules in the Unemployment Compensation Amendments of 1992 increased taxpayers' ability to determine the time of the income inclusion of pension distributions, and eliminated the need for special rules such as 5-year forward income averaging to prevent bunching of income.

The Congress believed that it is inappropriate to require all participants to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer. However, the accrued benefit of employees who retire after age 70-1/2 generally should be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits.

Explanation of Provisions

Lump-sum distributions

The Small Business Act repeals 5-year averaging for lump-sum distributions from qualified plans. Thus, the Small Business Act repeals the separate tax paid on a lump-sum distribution and also repeals the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution. The Small Business Act preserves the ability of certain individuals to elect 10-year averaging and capital gains treatment under the Tax Reform Act of 1986.

$5,000 exclusion for employer-provided death benefits

The Small Business Act repeals the $5,000 exclusion for employer-provided death benefits.

Recovery of basis

The Small Business Act provides that basis recovery on payments from qualified plans, qualified annuities, or tax-sheltered annuities generally is determined under a method similar to the prior-law simplified alternative method provided by the IRS. Under the Small Business Act, the portion of each annuity payment that represents a return of basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under the table below. The number of anticipated payments listed in the table is based on the employee's age on the annuity starting date. If the number of payments is fixed under the terms of the annuity, that number is used instead of the number of anticipated payments listed in the table.

Age	No. of Payments:
Not more than 55	360
56–60	310
61–65	260
66–70	210
More than 70	160

The simplified method is not available if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity. If, in connection with commencement of annuity payments, the recipient receives a lump-sum payment that is not part of the annuity stream, such payment is taxable under the rules relating to annuities (sec. 72) as if received before the annuity starting date, and the investment in the contract used to calculate the simplified exclusion ratio for the annuity payments is reduced by the amount of the payment. As under prior law, in no event is the total amount excluded from income as nontaxable return of basis greater than the recipient's total investment in the contract.

Required distributions

The Small Business Act modifies the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and generally replaces it with the rule in effect prior to the Tax Reform Act of 1986. Under the Small Business Act, distributions generally are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2 or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2. The Small Business Act does not provide any relief from the application of the anticutback rules (sec. 411(d)(6)) for plan amendments that would eliminate the ability of a plan participant who is not retired to begin distributions at age 70-1/2.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70-1/2, the Small Business Act generally requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan. Thus, under the Small Business Act, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70-1/2 and had begun receiving benefits at that time. It is intended that the actuarial adjustment rule does not apply in the case of defined contribution plans.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70-1/2 does not apply, under the Small Business Act, in the case of a governmental plan or church plan.

Effective Dates

Lump-sum distributions

The provision is effective for taxable years beginning after December 31, 1998.

$5,000 exclusion for employer-provided death benefits

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

Recovery of basis

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

Required distributions

The provision is effective for years beginning after December 31, 1996, with respect to distributions otherwise required to begin after such date. Thus, in the case of a participant who attains age 70-1/2 in 1996, the required distributions do not have to begin until April 1 of the year after the later of retirement or attainment of age 70-1/2. If a participant is currently receiving distributions, but does not have to under the provision, it is intended that a plan (or annuity contract) could (but would not be required to) permit the participant, with his or her consent, to stop receiving distributions until such distributions are required under the provision.

Revenue Effect

The repeal of 5-year income averaging is estimated to increase Federal fiscal year budget receipts by $74 million in 1997, $77 million in 1998, $108 million in 1999, $78 million in 2000, $70 million in 2001, $44 million in 2002, $17 million in 2003, and $15 million in 2004.

The repeal of the $5,000 death benefit exclusion is estimated to increase Federal fiscal year budget receipts by $28 million in 1997, $49 million in 1998, $52 million in 1999, $54 million in 2000, $55 million in 2001, $55 million in 2002, $56 million in 2003, $57 million in 2004, $57 million in 2005, and $58 million in 2006.

The simplified method for taxing annuity distributions under certain employer plans is estimated to increase Federal fiscal year budget receipts by $22 million in 1997, $28 million in 1998, $28 million in 1999, $29 million in 2000, $29 million in 2001, $29 million in 2002, $30 million in 2003, $30 million in 2004, $31 million in 2005, and $31 million in 2006.

The provision relating to minimum required distributions is estimated to decrease Federal fiscal year budget receipts by $1 million in 1997, $4 million in 1998, $4 million in 1999, $4 million in 2000, $4 million in 2001, $4 million in 2002, $4 million in 2003, $4 million in 2004, $4 million in 2005, and $4 million in 2006.

B. Increased Access to Retirement Savings Plans

1. Establish SIMPLE retirement plans for employees of small employers (secs. 1421-1422 of the Small Business Act and secs. 401(k) and 408(p) of the Code)

Present and Prior Law

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

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to $2,000. Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59-1/2 generally are subject to an additional 10-percent early withdrawal tax.

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

Under one type of qualified plan that can be maintained by an employer, employees can elect to reduce their taxable compensation and have nontaxable contributions made to the plan. Such contributions are called elective deferrals, and the plans which allow such contributions are called qualified cash or deferred arrangements (or "401(k) plans"). Like SARSEPs, the maximum annual amount of elective deferrals that can be made by an individual is $9,500 for 1996. A special nondiscrimination test applies to elective deferrals. An employer may make contributions based on an employee's elective contributions. Such contributions are called matching contributions, and are subject to a special nondiscrimination

test similar to the special nondiscrimination test applicable to elective deferrals.

Reasons for Change

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

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

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

Explanation of Provision

In general

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

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

SIMPLE retirement plans in IRA form

In general

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

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

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year. For purposes of determining the 2 percent of compensation nonelective contribution, no more than $150,000 of compensation (indexed in accordance with section 401(a)(17)) can be taken into account in any year with respect to any eligible employee. If such an election is made, the employer has to notify eligible employees of the change within a reasonable period before the 60-day election period for the year (described below). No contributions other than employee elective contributions and required employer matching contributions (or, alternatively, required employer nonelective contributions) can be made to a SIMPLE account.

Only employers who employ 100 or fewer employees who received compensation for the preceding year of at least $5,000 and who do not currently maintain a qualified plan can establish SIMPLE retirement accounts for their employees.[130]

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

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

Distributions from a SIMPLE plan generally are taxed as under the rules relating to IRAs, except that an increased early with-

[130] SIMPLE IRA plans of tax-exempt employers and State and local governments are not subject to the limits of section 457.

drawal tax (25 percent) applies to distributions within the first 2 years the employee first participates in the SIMPLE plan.

Tax treatment of SIMPLE accounts, contributions, and distributions

Contributions to a SIMPLE account generally are deductible by the employer. In the case of matching contributions, the employer is allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account are excludable from the employee's income. SIMPLE accounts, like IRAs, are not subject to tax. Distributions from a SIMPLE retirement account generally are taxed under the rules applicable to IRAs. Thus, they are includible in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account to another. A SIMPLE account can be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first participated in the SIMPLE plan. To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment), and 2 years have expired since the employee first participated in the plan, the employee may treat the SIMPLE account as an IRA.

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

Employer matching and nonelective contributions to a SIMPLE account are not subject to employment taxes or income tax withholding.

Administrative requirements

Each eligible employee can elect, within the 60-day period before the beginning of any year (or the 60-day period before first becoming eligible to participate), to participate in the SIMPLE plan (i.e., to make elective deferrals), and to modify any previous elections regarding the amount of contributions. An employer is required to contribute employees' elective deferrals to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate.[131] Employees must be allowed to terminate participation in the SIMPLE plan at any time during the year (i.e., to stop making contributions). The plan can provide that an employee who terminates participation cannot resume participation until the following year. A plan can permit (but is not required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions).

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[131] The Small Business Act did not amend the requirements of Title I of ERISA with respect to the time that contributions must be made to a plan. It is anticipated that the Secretary of Labor will provide that the rule applicable to salary reduction elective contributions requiring plan contributions to be made by no later than the 15th day of the month following the month in which such amounts would otherwise have been payable to the participant in cash is satisfied in the case of a SIMPLE plan if such contributions are made no later than the 30th day of the month following the month in which such contributions would otherwise have been paid in cash.

An employer is permitted to designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made, if the participant is notified in writing that the participant's balance may be transferred without cost or penalty. In such a case, the rules relating to SIMPLE accounts do not preclude the employer from opening a SIMPLE account on behalf of eligible employees.

Reporting requirements

The Small Business Act provides simplified reporting requirements for SIMPLE accounts and amends title I of ERISA to provide that no reports other than those specified by the Act may be required.

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

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

Fiduciary rules.—The Small Business Act amends title I of ERISA to provide that the employer (and any other plan fiduciary) is not subject to fiduciary liability resulting from the employee (or beneficiary) exercising control over the assets in the SIMPLE account. For this purpose, an employee (or beneficiary) is treated as exercising control over the assets in his or her account upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution (including a trustee-to-trustee transfer) to another SIMPLE account or IRA, or (3) one year after the SIMPLE account is established.

Definitions

For purposes of the rules relating to SIMPLE plans, compensation means compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation means net earnings from self-employment. The term employer includes the employer and related employers. Related employers includes trades or businesses under common control (whether incorporated or not),

controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules apply.

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

SIMPLE 401(k) plans

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

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

SIMPLE 401(k) plans established by tax-exempt employers are not subject to the limits on deferred compensation plans of such employers under section 457 of the Code.[132]

Repeal of SARSEPs

Under the Act, the present-law rules permitting SARSEPs are repealed.

Effective Date

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

The repeal of SARSEPs applies after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer is not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, can continue to receive contributions under present-law rules, and new employees of the employer hired after December 31,

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[132] State and local government employers are not eligible to maintain a SIMPLE section 401(k) plan because they are not eligible to maintain section 401(k) plans.

1996, can participate in the SARSEP in accordance with such rules.[133]

Revenue Effect

The provisions relating to SIMPLE plans and the repeal of SARSEPs are estimated to reduce Federal fiscal year budget receipts by $50 million in 1997, $76 million in 1998, $79 million in 1999, $81 million in 2000, $84 million in 2001, $87 million in 2002, $91 million in 2003, $94 million in 2004, $97 million in 2005, and $101 million in 2006.

2. Tax-exempt organizations eligible under section 401(k) (sec. 1426 of the Small Business Act and sec. 401(k) of the Code)

Present and Prior Law

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

Under present and prior law, there is no specific statutory provision governing the Federal income tax liability of Indian tribes.[134] However, the Internal Revenue Service ("IRS") has long taken the position that Indian tribal governments, as well as wholly-owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are immune from Federal income taxes.[135] More recently, the IRS has ruled that any income earned by an unincorporated Indian tribal government or Federally chartered tribal corporation is not subject to Federal income tax, regardless of whether the activities that produced the income are conducted on or off the tribe's reservation.[136] No inference is intended as to the Congress' view of the positions taken by the Internal Revenue Service.

Reasons for Change

The Congress believed that nongovernmental tax-exempt entities should be permitted to maintain qualified cash or deferred arrangements for their employees on the same basis as other employers.

Explanation of Provision

The Small Business Act allows tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an In-

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[133] A technical correction may be necessary so that the statute reflects this intent.

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

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

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

dian tribal government or subdivision thereof, or a corporation chartered under Federal, State, or tribal law which is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements. The Small Business Act retains the present-law prohibition against the maintenance of cash or deferred arrangements by State and local governments, except to the extent it may apply to Indian tribes.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1997, $22 million in 1998, $24 million in 1999, $25 million in 2000, $26 million in 2001, $28 million in 2002, $29 million in 2003, $30 million in 2004, $31 million in 2005, and $31 million in 2006.

3. Spousal IRAs (sec. 1427 of the Small Business Act and sec. 219 of the Code)

Present and Prior Law

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

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of a self-employed individual). Under prior law, in the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation), the $2,000 maximum limit on deductible IRA contributions is increased to $2,250.

The maximum permitted IRA deduction is phased out if the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan. The phase-out range is from $25,000 to $35,000 of adjusted gross income for single taxpayers and from $40,000 to $50,000 for married taxpayers filing a joint return.

Reasons for Change

The Congress was concerned about the national savings rate, and believed that individuals should be encouraged to save. The Congress believed that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive was not available to all taxpayers under prior law. The Congress believed that the prior-law rules relating to deductible IRAs penalized American homemakers. The Congress believed that IRA con-

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tributions should be permitted for both spouses even though only one spouse works.

Explanation of Provision

The Small Business Act modifies the rules relating to the maximum deductible IRA contribution by permitting deductible IRA contributions of up to $2,000 to be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. The Small Business Act does not modify the rules phasing out the maximum deduction in the case of an individual who is (or whose spouse is) an active participant in an employer-sponsored retirement plan.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $57 million in 1997, $168 million in 1998, $184 million in 1999, $195 million in 2000, $206 million in 2001, $219 million in 2002, $233 million in 2003, $248 million in 2004, $264 million in 2005, and $281 million in 2006.

C. Nondiscrimination Provisions

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

Prior Law

Definition of highly compensated employee

Under prior law, an employee, including a self-employed individual, is treated as highly compensated if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer, (2) received more than $100,000 (for 1996) in annual compensation from the employer, (3) received more than $66,000 (for 1996) in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year, or (4) was an officer of the employer who received compensation in excess of $60,000 (for 1996). If, for any year, no officer had compensation in excess of the threshold, then the highest paid officer of the employer was treated as a highly compensated employee.

Family aggregation rules

Under prior law, a special rule applied with respect to the treatment of family members of certain highly compensated employees for purposes of the nondiscrimination rules applicable to qualified plans. Under the special rule, if an employee was a family member of either a 5-percent owner or 1 of the top-10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on

behalf of such family member was aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top-10 employees by compensation. Therefore, such family member and employee were treated as a single highly compensated employee. An individual was considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouses of a lineal ascendant or descendant of the employee.

Similar family aggregation rules applied with respect to the $150,000 (for 1996) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(l)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained age 19 were taken into account.

Reasons for Change

Under prior law, the administrative burden on plan sponsors to determine which employees were highly compensated could be significant. The various categories of highly compensated employees required employers to perform a number of calculations that for many employers had largely duplicative results.

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

Explanation of Provision

Definition of highly compensated employee

Under the Small Business Act, an employee is treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $80,000 (indexed for inflation) or (b) at the election of the employer had compensation for the preceding year in excess of $80,000 (indexed for inflation) and was in the top 20 percent of employees by compensation for such year. The Act also repeals the rule requiring the highest paid officer to be treated as a highly compensated employee. The employer can make the election described in (2)(b) annually without the consent of the Secretary.

Family aggregation rules

The Small Business Act repeals the family aggregation rules.

Effective Date

The provisions are effective for years beginning after December 31, 1996, except that in determining whether an employee is highly compensated in 1997, the provisions are treated as effective in 1996. Thus, in determining whether someone was highly com-

pensated in 1997, the family aggregation rules do not apply in determining the employee's compensation for 1996.

Revenue Effect

The estimated effect of the modified definition of highly compensated employee and the repeal of the family aggregation rules on Federal fiscal year budget receipts generally is included with other provisions.

2. Modification of additional participation requirements (sec. 1432 of the Small Business Act and sec. 401(a)(26) of the Code)

Prior Law

Under prior law, a plan was not a qualified plan unless it benefited no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement could not be satisfied by aggregating comparable plans, but could be applied separately to different lines of business of the employer. A line of business of the employer did not qualify as a separate line of business unless it had at least 50 employees.

Reasons for Change

The minimum participation rule was adopted in the Tax Reform Act of 1986 because the Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for nondiscrimination purposes are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of highly compensated employees.

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

Also, the arbitrary requirement that a line of business must have at least 50 employees requires application of the minimum participation rule on an employer-wide basis in some cases in which the employer truly has separate lines of business.

Explanation of Provision

The Small Business Act provides that the minimum participation rule applies only to defined benefit pension plans. In addition, the Act provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee).

The Small Business Act provides that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective Date

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

Revenue Effect

The modification to the minimum participation rule is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Present and Prior Law

Under present and prior law, a profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $9,500 for 1996. This dollar limit is indexed for inflation. A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test is satisfied if the actual deferral percentage (ADP) for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test (the actual contribution percentage ("ACP") test) similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. The special nondiscrimination test is satisfied for a plan year if the ACP for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the ACP for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The ACP for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and after-tax employee contributions on behalf of each such employee to the employee's compensation for the year. Employer matching contributions that satisfy certain requirements can be used to satisfy the ADP test, but, to the extent so used, such contributions cannot be considered when calculating the ACP test.

A plan that would otherwise fail to meet the special nondiscrimination test for qualified cash or deferred arrangements is not treated as failing such test if excess contributions (with allocable income) are distributed to the employee or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions. For purposes of this rule under prior law, in determining the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees were reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages. A similar rule applied to employer matching contributions.

Reasons for Change

The sources of complexity generally associated with the nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests.

The Congress believed that the complexity of nondiscrimination requirements, particularly after the Tax Reform Act of 1986 changes that imposed a dollar cap on elective deferrals ($9,500 in 1996), was not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. The result that the nondiscrimination rules are intended to produce can also be achieved by creating an incentive for employers to provide certain matching contributions or nonelective contributions on behalf of rank-and-file employees. Such contributions should create a sufficient inducement to rank-and-file employee participation. Thus, the Congress believed it appropriate to provide a design-based safe harbor for qualified cash or deferred arrangements. Plans that satisfy the safe harbors would not have to satisfy the nondiscrimination tests for cash or deferred arrangements.

In addition, the significant simplification that a design-based safe harbor test achieves may reduce the complexity of the qualified cash or deferred arrangement requirements enough to encourage additional employers to establish such plans, thereby expanding employee access to voluntary retirement savings arrangements. The adoption of a nondiscrimination safe harbor that eliminates the testing of actual plan contributions removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, particularly small employers, who do not now provide any tax-favored retirement plan for their employees, to set up such plans.

A design-based nondiscrimination test provides certainty to an employer and plan participants that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year.

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

Explanation of Provisions

In general

The Small Business Act modifies the prior-law nondiscrimination test applicable to elective deferrals (and employer matching and after-tax employee contributions) to provide that the maximum permitted ADP (or ACP) for highly compensated employees for the year is generally determined by reference to the ADP (or ACP) for nonhighly compensated employees for the preceding, rather than the current, year.

In addition, the Small Business Act adds alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement is treated as satisfying the ADP test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan satisfies the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions. These safe harbors permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions.

The Small Business Act also modifies the method of determining excess contributions under the present-law nondiscrimination test.

Prior-year data

The Small Business Act modifies the special nondiscrimination tests applicable to elective deferrals (and employer matching and after-tax employee contributions) to provide that the maximum permitted ADP (and ACP) for highly compensated employees for the year is determined by reference to the ADP (and ACP) for nonhighly compensated employees for the preceding, rather than the current, year. There is no (required or permitted) recalculation involved in applying the prior year data. For example, the prior year information is used even if the number of persons who are nonhighly compensated in the prior year is different that the number of persons who are nonhighly compensated in the current year. Similarly, using prior-year data in 1997, the data for 1996 is used, even though the definition of highly compensated employee (and therefore nonhighly compensated employee) was different in 1996 than it is in 1997. The data for the 1996 year is not recalculated using the new definition of highly compensated employee.

A special rule applies for the first plan year. In the case of the first plan year of any plan (other than a successor plan), the amount taken into account as the ADP (or ACP) for nonhighly compensated employees for the prior year is generally 3 percent. Alternatively, the employer can elect to use the ADP (or ACP) for such first plan year.

Instead of using prior-year data, an employer is allowed to elect to use the current year ADP (and ACP). Such an election can be revoked only as provided by the Secretary.

Safe harbor for cash or deferred arrangements

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

A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement. The contribution requirement must be met without regard to the permitted disparity rules (sec. 401(l)).

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to 3 percent of compensation and (b) 50 percent of the employee's elective deferrals from 3 to 5 percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution is not equal to the percentages described in the preceding paragraph, the matching contribution requirement is deemed to be satisfied if (1), the rate of an employer's matching contribution does not increase as an employee's rate of elective deferral increases and (2), the aggregate amount of matching contributions at such rate of elective deferral at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements. For example, the alternative test is satisfied if an employer matches 125 percent of an employee's elective deferral up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. However, the alternative test is not satisfied if an employer matches 80 percent of an employee's elective deferrals up to the first 5 percent of compensation. The former example satisfies the alternative test because the employer match does not increase and the aggregate amount of matching contributions at any rate of elective deferral is at least equal to the aggregate amount of matching contributions required under the general safe harbor rule. The latter example does not satisfy the alternative test because the aggregate amount of matching contributions at any rate of elective deferral does not equal the aggregate amount of matching contributions required under the general safe harbor rule.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are required to be nonforfeitable and are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)). It is intended that employer matching and nonelective contributions used

to satisfy the contribution requirements of the safe harbor rules generally can be used to satisfy other qualified retirement plan nondiscrimination rules (except the special nondiscrimination test applicable to employer matching contributions (the ACP test)). So, for example, a cross-tested defined contribution plan that includes a qualified cash or deferred arrangement can consider such employer matching and nonelective contributions in testing.[137] However, contributions used to satisfy the safe harbor cannot be taken into account in determining whether a plan meets the permitted disparity rules (sec. 401(l)).

The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before any year, of the employee's rights and obligations under the arrangement.

Alternative method of satisfying special nondiscrimination test for matching contributions

The Small Business Act provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test). Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if (1), the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2), the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if: (1), the employer matching contributions on behalf of any employee may not be made with respect to employee after-tax contributions or elective deferrals in excess of 6 percent of compensation; (2), the rate of an employer's matching contribution does not increase as the rate of an employee's after-tax contributions or elective deferrals increases; and (3), the matching contribution with respect to any highly compensated employee at any rate of employee after-tax contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

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

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

Distribution of excess contributions and excess aggregate contributions

The Small Business Act provides that the total amount of excess contributions (and excess aggregate contributions) is determined as under prior law, but the distribution of excess contributions (and excess aggregate contributions) are required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, excess contributions (and excess aggregate contributions) are deemed attributable first to those highly compensated employees who have the greatest dollar amount of elective deferrals. This modified distribution method also applies to excess contributions that are treated as distributed to an employee and then contributed by the employee to the plan (recharacterization).

For example, assume that an employer maintains a qualified cash or deferred arrangement under section 401(k). Assume further that the ADP for the eligible nonhighly compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly compensated employees:

Employees	Compensation	Deferral	Deferral (percent)
A	$200,000	$7,000	3.5
B	200,000	7,000	3.5
C	70,000	7,000	10.0
D	70,000	5,250	7.5
E	70,000	2,100	3.0
F	70,000	1,750	2.5

Under these facts, the highly compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under prior law, the highly compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly compensated employees is 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e., a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the Small Business Act, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600. The ADP test would not be performed again.

It is intended that the Secretary interpret and apply the section 401(k) and 401(m) nondiscrimination tests in a manner consistent with the modified distribution rule. For example, a plan will not fail to be a qualified cash or deferred arrangement merely because the plan fails to satisfy the section 401(k) nondiscrimination test after excess contributions are distributed or recharacterized under the modified distribution rule.

Effective Date

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

Revenue Effect

The provision relating to use of prior-year data and the modification of the method for distributing excess contributions are estimated to have a negligible effect on Federal fiscal year budget receipts. The designed-based safe harbors for elective deferrals and employer matching contributions are estimated to reduce Federal fiscal year budget receipts by $45 million in 1999, $166 million in 2000, $171 million in 2001, $175 million in 2002, $180 million in 2003, $186 million in 2004, $191 million in 2005, and $196 million in 2006.

4. Definition of compensation for purposes of the limits on contributions and benefits (sec. 1434 of the Small Business Act and sec. 415 of the Code)

Present and Prior Law

Present and prior law imposes limits on contributions and benefits under qualified plans based on the type of plan. In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $120,000 (for 1996). In the case of a defined contribution plan, the limit on annual additions is the lesser of (1) 25 percent of compensation or (2), $30,000 (for 1996, otherwise 1/4 of the defined benefit dollar limit). For purposes of these limits, prior law provided that compensation generally does not include elective employee contributions to certain employee benefit plans.

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in each of 1998 and 1999, $2 million in each of 2000 through 2004, and $3 million in each of 2005 and 2006.

D. Miscellaneous Pension Simplification

1. Plans covering self-employed individuals (sec. 1441 of the Small Business Act and sec. 401(d) of the Code)

Prior Law

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under prior law, certain special aggregation rules applied to plans maintained by owner employees of unincorporated businesses that do not apply to other qualified plans (sec. 401(d)(1) and (2)).

Reasons for Change

The Congress believed that the remaining special aggregation rules for plans maintained by unincorporated employers are unnecessary and should be eliminated. Applying the same set of rules to all types of plans should make the qualification standards easier to apply and administer.

Explanation of Provision

The Small Business Act eliminates the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

2. Elimination of special vesting rule for multiemployer plans (sec. 1442 of the Small Business Act and sec. 411(a) of the Code)

Present and Prior Law

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

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

Reasons for Change

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

Explanation of Provision

The Small Business Act conforms the vesting rule for multiemployer plans to the rules applicable to other qualified plans.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1997, and by $1 million in each of 1998 through 2006.

3. Distributions under rural cooperative plans (sec. 1443 of the Small Business Act and sec. 401(k)(7) of the Code)

Present and Prior Law

Under present and prior law, a qualified cash or deferred arrangement can permit withdrawals of employee elective deferrals only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, or (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59-1/2 or the occurrence of a hardship of the participant. Under prior law, in the case of a money purchase pension plan, including a rural cooperative plan, withdrawals by participants could not occur upon attainment of age 59-1/2 or upon hardship.

Reasons for Change

The Congress believed that it is appropriate to permit qualified cash or deferred arrangements of rural cooperatives to permit distributions to plan participants under the same circumstances as other qualified cash or deferred arrangements. Also, the Congress believed that it is appropriate to clarify that certain public utility districts and a national association of rural cooperatives should be treated as rural cooperatives for this purpose.

Explanation of Provision

The Small Business Act provides that a rural cooperative plan that includes a cash or deferred arrangement may permit distributions to plan participants after the attainment of age 59-1/2 or on account of hardship. In addition, the definition of a rural cooperative is expanded to include certain public utility districts.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

4. Treatment of governmental plans under section 415 (sec. 1444 of the Small Business Act and secs. 415 and 457 of the Code)

Present and Prior Law

Present and prior law impose limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). Certain special rules apply to State and local governmental plans under which such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensa-

tion or (2) $120,000 (indexed for inflation). The dollar limit is reduced in the case of early retirement or if the employee has less than 10 years of plan participation.

Reasons for Change

The limits on contributions and benefits create unique problems for plans maintained by public employers.

Explanation of Provision

The Small Business Act makes the following modifications to the limits on contributions and benefits as applied to governmental plans:

(1) the 100 percent of compensation limitation on defined benefit pension plan benefits does not apply; and

(2) the early retirement reduction and the 10-year phase-in of the defined benefit pension plan dollar limit does not apply to certain disability and survivor benefits.

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

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

5. Uniform retirement age (sec. 1445 of the Small Business Act and sec. 401(a)(5) of the Code)

Present and Prior Law

Under present and prior law, a qualified plan generally must provide that payment of benefits under the plan must begin no later than 60 days after the end of the plan year in which the participant reaches age 65. Also, for purposes of the vesting and benefit accrual rules, normal retirement age generally can be no later than age 65. For purposes of applying the limits on contributions and benefits (sec. 415), social security retirement age is generally used as retirement age. The social security retirement age as used for such purposes is presently age 65, but is scheduled to gradually increase. Qualified plans are subject to nondiscrimination rules that are designed to ensure that plan benefits are not discriminatory in favor of highly compensated employees.

Reasons for Change

Many plans base benefits on social security retirement age so that the benefits under the plan complement social security. Under present law, plans that do so may fail applicable nondiscrimination tests. The Congress believed that the social security retirement age is an appropriate age for use under plans maintained by private employers.

Explanation of Provision

The Small Business Act provides that for purposes of the general nondiscrimination rules (sec. 401(a)(4)) the social security retirement age (as defined in sec. 415) is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities are not treated as not being available to employees on the same terms merely because they are based on an employee's social security retirement age (as defined in sec. 415).

Effective Date

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

Revenue Effect

The revenue effect of the provision is considered in other provisions.

6. Contributions on behalf of disabled employees (sec. 1446 of the Small Business Act and sec. 415(c)(3) of the Code)

Prior Law

Under prior law, an employer could elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee was deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Under prior law, contributions were not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Reasons for Change

The Congress believed that it is appropriate to facilitate the provision of benefits for disabled employees, if it is done on a nondiscriminatory basis.

Explanation of Provision

The Small Business Act provides that the prior-law special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Present and Prior Law

Under a general principle of the Federal income tax system, individuals are taxed currently not only on compensation actually received, but also on compensation constructively received during the taxable year. An exception to this rule applies to compensation deferred under an eligible unfunded deferred compensation plan (a "sec. 457 plan") of a tax-exempt or State or local governmental employer. Under a section 457 plan, compensation that is deferred is includible in income when such amounts are paid or made available. Under prior law, the maximum annual deferral under such a plan was the lesser of (1) $7,500 or (2) 33-1/3 percent of compensation (net of the deferral).

In general, amounts deferred under a section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant is separated from service with the employer, or (3) when the participant is faced with an unforeseeable emergency. Amounts that are made available upon separation from service are includible in gross income in the taxable year in which they are made available.

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

Reasons for Change

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

Explanation of Provision

The Small Business Act makes three changes to the rules governing section 457 plans.

First, the Small Business Act permits in-service distributions of accounts that do not exceed $3,500 if no amount has been deferred under the plan with respect to the account for 2 years and there has been no prior distribution under this cash-out rule.

Second, the Small Business Act increases the number of elections that can be made with respect to the time distributions must begin under the plan. The Act provides that the amount payable to a participant under a section 457 plan is not treated as made available merely because the participant may elect to defer commencement of distributions under the plan if (1) the election is made after amounts may be distributed under the plan but before the actual commencement of benefits, and (2) the participant makes only 1 such additional election. This additional election is permitted without the need for financial hardship. The election can only be to a date that is after the date originally selected by the participant.

Third, the Small Business Act provides for indexing of the $7,500 dollar limit on deferrals (in $500 increments).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1997, by $1 million in each of 1998 through 2000, and by $2 million in each of 2001 through 2006.

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

Present and Prior Law

Compensation deferred under an eligible unfunded deferred compensation plan (a "sec. 457 plan") of a tax-exempt or State and local governmental employer is not includible in gross income until paid or made available.

Under prior law, one of the requirements of a section 457 plan was that (until the compensation was made available to the participant) all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights had to remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors. Consequently, compensation deferred by employees under a section 457 plan were not protected from the employer's general creditors in case of the employer's bankruptcy.

Under present and prior law, amounts deferred under plans of tax-exempt and governmental employers that do not meet the requirements of section 457 are includible in gross income in the first year in which there is no substantial risk of forfeiture of such amounts.

Reasons for Change

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

Explanation of Provision

Under the Small Business Act, all amounts deferred (including amounts deferred prior to the effective date of the Act) under a section 457 plan maintained by a State and local governmental employer are to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. Consequently, the requirement that amounts deferred under a section 457 plan be subject only to the claims of the employer's creditors is repealed with respect to State and local governmental section 457 plans. The trust (or custodial account or annuity contract) is provided tax-exempt status and, as under prior law, amounts are not includible in income until made available to the employee as provided in section 457. Amounts are not considered made available merely because they are held in a trust, custodial account, or annuity contract. It is intended that the income inclusion rules in the Code (secs. 83 and 402(b)) do not apply to amounts deferred under a section 457 plan (and income thereon) merely because such amounts are contributed to the trust (or custodial account or annuity contract).

It is intended under the Small Business Act that amounts held in trust (or custodial account or annuity contract) may be loaned to plan participants (or beneficiaries) pursuant to rules applicable to loans from qualified plans (sec. 72(p)).[138] A section 457 plan may, but is not required to, permit loans.

All other prior-law requirements applicable to section 457 plans (as modified by other provisions of the Small Business Act), including the annual limit on the maximum amount of deferral and the restrictions on when amounts deferred can be made available, still apply. Thus, to the extent these requirements, including the trust requirement, are not satisfied, amounts deferred are includible in the employee's income when there is no substantial risk of forfeiture.

The Small Business Act does not modify the present-law rules applicable to section 457 plans of nongovernmental tax-exempt employers or the rules applicable to nonqualified plans of other employers.

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[138] Under section 72(p), in general, a loan from a plan is treated as a distribution unless the loan (1) does not exceed certain dollar limits (generally, the lesser of $50,000 or one-half of the participant's vested benefit); (2) must be repaid within 5 years; and (3) must be amortized on a substantially level basis with payments at least quarterly.

Effective Date

The provision generally is effective with respect to amounts held on or after the date of enactment. In the case of plans in existence on the date of enactment, the trust requirement does not have to be satisfied until January 1, 1999. Thus, deferrals prior to and after the date of enactment under such plans (and earnings thereon) do not have to be held in trust (or custodial account or annuity contract) until January 1, 1999.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $7 million in 1997, $21 million in 1998, $24 million in 1999, $25 million in 2000, $25 million in 2001, $26 million in 2002, $27 million in 2003, $28 million in 2004, $29 million in 2005, and $30 million in 2006.

9. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act (sec. 1449 of the Small Business Act, sec. 415 of the Code, and sec. 767 of the General Agreement on Tariffs and Trade)

Present and Prior Law

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

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

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

Reasons for Change

The Congress was aware that the GATT provisions enacted in the 103rd Congress had the result of reducing the benefit payments to certain pension plan beneficiaries. The Congress believed that it was appropriate to ameliorate this result by providing the same transition period for the modifications to limits on contributions and benefits to that provided under similar GATT provisions, and

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

Explanation of Provision

The Small Business Act conforms the effective date of the new interest rate and mortality assumptions that must be used under section 415 to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions. This rule applies only in the case of plans that were adopted and in effect before the date of enactment of GATT (December 8, 1994). To the extent plans have already been amended to reflect the new assumptions, plan sponsors are permitted within 1 year of the date of enactment to amend the plan to reverse retroactively such amendment.[139]

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

Effective Date

The provision is effective as if included in GATT.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in each of 1997 through 1999.

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

Present and Prior Law

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

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

ment must be irrevocable with respect to amounts earned while the agreement is in effect.

Under present and prior law, these restrictions do not apply to other elective deferral arrangements such as a qualified cash or deferred arrangement (sec. 401(k)). Under Treasury regulations, (1) participants in a qualified cash or deferred arrangement may enter into more than one salary reduction agreement in a taxable year, (2) such an agreement is effective with respect to compensation not available to the participant until after the agreement becomes effective even though previously earned, and (3) the agreement may be revoked by the participant.

Reasons for Change

The Congress believed that it is appropriate to conform the treatment of salary reduction agreements under section 403(b) to the treatment of qualified cash or deferred arrangements.

Explanation of Provision

The Small Business Act provides that, for participants in a tax-sheltered annuity plan, the frequency with which a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement is determined under the rules applicable to qualified cash or deferred arrangements.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Prior Law

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

Reasons for Change

The Congress believed that there is some uncertainty under present law about the ability of Indian tribal governments to establish 403(b) plans for all tribal government employees. Following enactment of the Indian Tribal Government Tax Status Act of 1982, several insurance companies and financial advisors marketed 403(b) plans to tribes representing that the plans could be adopted

on a tribal-wide basis to cover all employees. As a result, many tribes adopted 403(b) plans for their employees that were not in compliance with the law. Given this uncertainty, the Congress believed it appropriate to requalify such plans.

Explanation of Provision

The Small Business Act provides that any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The Act also provides that such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Prior Law

Under prior law, a tax-sheltered annuity plan was required to provide that elective deferrals made under the plan on behalf of an employee could not exceed the annual limit on elective deferrals ($9,500 for 1996). Plans that did not comply with this requirement could lose their tax-favored status.

Reasons for Change

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

Explanation of Provision

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

is attributable to reasonable error, the contract will not fail to satisfy section 403(b), and only the portion of the elective deferral in excess of the annual limit is includible in gross income.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

13. Waiver of minimum waiting period for qualified plan distributions (sec. 1451 of the Small Business Act, sec. 417(c) of the Code and sec. 205(c) of ERISA)

Prior Law

Under present and prior law, in the case of a qualified joint and survivor annuity, a written explanation of the form of benefit must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting date. Under prior law,[140] even if a participant elected to waive the qualified joint and survivor annuity and the spouse consented to the distribution, the distribution from the plan could not be made until 30 days after the written explanation was provided to the participant. On September 15, 1995, Treasury issued temporary regulations (T.D. 8620) which provide that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation was provided, as long as the distribution commences more than 7 days after the explanation was provided. Consequently, even if the participant (and spouse, if applicable) has elected to waive the minimum waiting period for receiving a qualified plan distribution, the distribution from the plan cannot be made until 7 days have elapsed after the explanation was provided to the participant.

Reasons for Change

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

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[140] Treas. Reg. sec. 1.417(e)-1(b)(3).

Explanation of Provision

The Small Business Act adopts the Treasury temporary regulation and provides that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation was provided, as long as the distribution commences more than 7 days after the explanation was provided. The Small Business Act also provides that a plan is permitted to provide the explanation after the annuity starting date if the distribution commences at least 30 days after such explanation was provided, subject to the same waiver of the 30-day minimum waiting period as described above. This is intended to allow retroactive payments of benefits which are attributable to the period before the explanation was provided.

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

14. Repeal of combined plan limit and temporary waiver of excess distribution tax (sec. 1452 of the Small Business Act and secs. 415(e) and 4980A of the Code)

Present and Prior Law

Limits on contributions and benefits

In general

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

Defined contribution plan limit

Under a defined contribution plan, annual additions to the plan with respect to each participant for a limitation year cannot exceed the lesser of (1) 25 percent of compensation or (2) $30,000 (for 1996). Annual additions generally are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit is indexed for inflation in $5,000 increments.

Defined benefit plan limit

The limit on the annual benefit payable to (or with respect to) a participant by all defined benefit pension plans of the same employer is generally the lesser of (1) 100 percent of average compensation for the three years in which it was the highest, or (2)

$120,000 (for 1996). The $120,000 limit is indexed for inflation in $5,000 increments. If a benefit is payable under the plan in a form other than a straight life annuity, then the benefit must be actuarially adjusted to an equivalent annual straight life annuity before applying the limit on benefits. In addition, if a benefit is payable beginning at an age other than the participant's social security retirement age, the $120,000 dollar limitation is actuarially adjusted so that it equals an annual benefit that is equivalent to the dollar limitation at the participant's social security retirement age. The limit is reduced if benefits begin before social security retirement age, and increased if benefits begin after social security retirement age.

Combined plan limit

Under prior law, an additional limit applied if an employee participated in both a defined benefit pension plan and a defined contribution plan maintained by the same employer (sec. 415(e)). The combined plan limitation was designed to prevent avoidance of the separate plan limits through the creation of different types of plans.

The combined limit was satisfied if the sum of the "defined benefit plan fraction" and the "defined contribution plan fraction" was not greater than 1.0. Although the sum of these fractions could not exceed 1.0, the plan fractions effectively provided an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied with respect to the percentage limits).

The defined benefit plan fraction was designed to measure the portion of the maximum permitted defined benefit plan limit that the employee actually uses. The numerator was the participant's projected normal retirement benefit determined at the close of the year. The denominator was generally the lesser of 125 percent of the dollar limitation for the year, or 140 percent of the employee's average compensation for the three years of employment in which the employee's average compensation was highest.

The defined contribution plan fraction measured the portion that the employee actually uses of the maximum permitted contributions to a defined contribution plan for the employee's total years of service with the employer. The numerator was generally the total of the contributions and forfeitures allocated to the employee's account for each of the employee's years of service with the employer through the close of the year for which the fraction was being determined. The denominator was the sum of the lesser of the following amounts, computed separately for such year and each prior year of service with the employer: (1) 125 percent of the dollar amount in effect for such year, or (2) 140 percent of the 25 percent of compensation limit for the participant.

Excess distribution tax

Present and prior law impose a 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $150,000 (or $750,000 in the case of a lump-

sum distribution). An additional 15-percent estate tax is also imposed on an individual's excess retirement accumulation.

Reasons for Change

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

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

Explanation of Provisions

Combined plan limit

The Small Business Act repeals the combined plan limit.

Excess distribution tax

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

Effective Date

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

Revenue Effect

The repeal of the combined plan limit is estimated to reduce Federal fiscal year budget receipts by $72 million in 2000, $195 million in 2001, $201 million in 2002, $207 million in 2003, $213 million in 2004, $219 million in 2005, and $226 million in 2006. The temporary waiver of the excess distribution tax is estimated to increase Federal fiscal year budget receipts by $42 million in 1997, $44 million in 1998, $47 million in 1999, and $32 million in 2000.

15. Tax on prohibited transactions (sec. 1453 of the Small Business Act and sec. 4975 of the Code)

Present and Prior Law

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

Reasons for Change

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

Explanation of Provision

The Small Business Act increases the initial-level prohibited transaction tax from 5 percent to 10 percent. No changes were made to the prohibited transaction provisions of Title I of ERISA.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in 1997 and by $4 million in each of 1998 through 2006.

16. Treatment of leased employees (sec. 1454 of the Small Business Act and sec. 414(n) of the Code)

Present and Prior Law

An individual (a leased employee) who performs services for another person (the recipient) may be required to be treated as the recipient's employee for various employee benefit provisions, if the services are performed pursuant to an agreement between the recipient and any other person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a year, and, under prior law, the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing

organization meeting certain requirements. Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Reasons for Change

The leased employee rules are complex and have unexpected and sometimes indefensible results, especially as interpreted under regulations proposed by the Secretary. For example, under the "historically performed" standard, the employees and partners of a law firm may be the leased employees of a client of the firm if they work a sufficient number of hours for the client and if it is not unusual for employers in that business field to have in-house counsel. While arguably meeting the present-law leased employee definition, the Congress believed that situations such as this are outside the intended scope of the rules.

Explanation of Provision

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

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

For example, an individual who works under the direct supervision of the service recipient would be considered to be subject to the primary direction or control of the service recipient even if another company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the ex-

clusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the service recipient in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached.

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

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

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

In many cases, the "historically performed" test is overly broad, and results in the unintended treatment of individuals as leased employees. One of the principal purposes for changing the leased employee rules is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. However, it is not intended that the primary direction or control test enable employers to engage in abusive practices. Thus, it is intended that the Secretary of the Treasury interpret and apply the leased employee rules in a manner so as to prevent abuses. This ability to prevent abuses under the leasing rules is in addition to the present-law authority of the Secretary of the Treasury under section 414(o). For example, one potentially abusive situation exists where the benefit

arrangements of the service recipient overwhelmingly favor its highly compensated employees, the employer has no or very few nonhighly compensated common-law employees, yet the employer makes substantial use of the services of nonhighly compensated individuals who are not its common-law employees.

Effective Date

The provision is effective for years beginning after December 31, 1996, except that it does not apply to relationships that have been previously determined by an Internal Revenue Service ruling issued before the date of enactment not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, it is intended that the Secretary of the Treasury use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Present and Prior Law

Under present and prior law, any person who fails to file an information report with the Internal Revenue Service ("IRS") on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). Under prior law, a different, flat-amount penalty applied for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

Reasons for Change

The Congress believed that conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure would simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

Explanation of Provision

The Small Business Act incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments are treated in a similar fashion to other information reports. The Small Business Act also modifies the penalty for failure to provide the notice re-

quired with respect to distributions that are eligible for rollover treatment (sec. 402(b)).

Effective Date

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

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

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

Prior Law

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

19. Treasury to provide sample language for spousal consent forms and qualified domestic relations orders (sec. 1457 of the Small Business Act, secs. 414(p) and 417(a)(2) of the Code, and secs. 205(c)(2) and 206(d)(3) of ERISA)

Present and Prior Law

Present and prior law contain a number of rules designed to provide income to the surviving spouse of a deceased employee. Under these spousal protection rules, defined benefit pension plans and money purchase pension plans are required to provide that vested retirement benefits with a present value in excess of $3,500 are

payable in the form of a qualified joint and survivor annuity ("QJSA") or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity ("QPSA").

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

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

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

The QJSA, QPSA, and QDRO rules are also contained in title I of the Employee Retirement Income Security Act ("ERISA").

Reasons for Change

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

Explanation of Provision

The Secretary of the Treasury is required to develop sample language for inclusion in a spousal consent form waiving the QJSA and QPSA forms of benefit. Such form must be written in a manner calculated to be understood by the average person, and must disclose in plain form whether the waiver is irrevocable and that it may be revoked by a QDRO.

The Secretary is also required to develop a sample language for inclusion in a QDRO. The sample language must satisfy the requirements of a QDRO under the Code and ERISA, and focus at-

tention on the need to consider the treatment of any lump sum payment, QJSA, or QPSA.

The Secretary is also directed to include publicity for the sample language in the pension outreach efforts undertaken by the Secretary.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

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

Present and Prior Law

Under section 457 of the Code, compensation deferred under an eligible deferred compensation plan of a tax-exempt or governmental employer that meets certain requirements is not includible in gross income until paid or made available. One of the requirements for a section 457 plan is that the maximum annual amount that can be deferred is the lesser of $7,500 or 33-1/3 percent of the individual's taxable compensation. This maximum limit is coordinated with the annual limit on elective deferrals under qualified cash or deferred arrangements (sec. 401(k) plans) and under tax-sheltered annuities (sec. 403(b) plans), which is $9,500 for 1996. Under this rule, elective deferrals to section 401(k) and 403(b) plans are treated as amounts deferred under a section 457 plan (and vice versa). Thus, for example, if an individual who is a participant in both a section 403(b) plan and a section 457 plan elects to contribute $2,000 to the 403(b) plan, then the maximum amount that can be deferred in that year under the section 457 plan is $5,500.

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

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

Reasons for Change

The Congress believed it was both appropriate and important to allow for the provision of length of service awards to volunteer fire-

fighters, and other emergency medical (including ambulance services) personnel.

Explanation of Provision

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

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1997, $5 million in 1998, $7 million in 1999, $9 million in 2000, $11 million in 2001, $13 million in 2002, $16 million in 2003, $18 million in 2004, $20 million in 2005, and $23 million in 2006.

21. Alternative nondiscrimination rules for certain plans that provide for early participation (sec. 1459 of the Small Business Act and sec. 401(k) of the Code)

Present and Prior Law

Under present and prior law, a special nondiscrimination test applies to qualified cash or deferred arrangements (sec. 401(k) plans). The special nondiscrimination test is satisfied if the actual deferral percentage ("ADP") for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test (the actual contribution percentage ("ACP") test) similar to the special nondiscrimination

test applicable to elective deferrals under qualified cash or deferred arrangements.

In general, a qualified plan need not permit employees to enter the plan prior to the attainment of age 21 and the completion of 1 year of service. For purposes of the nondiscrimination rules (including the ADP and ACP tests), an employer that chooses less restrictive entry conditions (e.g., age 18 rather than age 21) may choose "separate testing" under which all employees who have not met the statutory age and service entry maximums are disregarded, provided that the plan satisfies the nondiscrimination rules taking into account only those employees whose age and service are less than the statutory age and service maximums. Thus, for example, such a plan would apply one ADP test for employees who are over age 21 with 1 year of service, under which the plan would disregard elective contributions for other employees, and a second ADP test looking solely at elective contribution for employees under age 21 or who have not completed 1 year of service.

Reasons for Change

The Congress believed that some employers may be reluctant to include new or younger employees (i.e., employees under age 21) in a section 401(k) plan out of concern that participation by such employees may cause the plan to fail to satisfy the ADP test because they may tend to have lower deferral percentages. The Congress believed that employers should be encouraged to include such employees in their section 401(k) plans.

Explanation of Provision

Under the Small Business Act, for purposes of the ADP test, an employer may elect to disregard employees (other than highly compensated employees) eligible to participate in the plan before they have completed 1 year of service and reached age 21, provided the plan separately satisfies the minimum coverage rules of section 410(b) taking into account only those employees who have not completed 1 year of service or are under age 21. Thus, instead of applying two separate ADP tests, a single ADP test would be applied that compares the ADP for all highly compensated employees who are eligible to make elective contributions with the ADP for those nonhighly compensated employees who are eligible to make elective contributions and who have completed one year of service and reached age 21. A similar rule applies for purposes of the ACP test. The rule does not apply for the design-based safe harbor provided under the Small Business Act.

Effective Date

The provision is effective for plan years beginning after December 31, 1998.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $6 million in 1999, $17 million in 2000, $18 million in

2001, $19 million in 2002, $19 million in 2003, and $20 million in each of 2004 through 2006.

22. Clarification of application of ERISA to insurance company general accounts (sec. 1460 of the Small Business Act and sec. 401 of ERISA)

Present Law

The Employee Retirement Income Security Act of 1974, as amended, ("ERISA")[141] imposes certain fiduciary requirements (including restrictions on certain prohibited transactions) with respect to the assets of an employee benefit plan ("plan assets"). The Code imposes an excise tax in the case of certain prohibited transactions involving plan assets (Code sec. 4975).

In 1975, the Department of Labor issued Interpretive Bulletin 1975-2 which provided that if an insurance company issues a contract or policy of insurance to an employee benefit plan and places the consideration of such contract or policy in its general asset account, the assets in such account are not considered to be plan assets.[142] However, on December 13, 1993, the Supreme Court, in *John Hancock Mutual Life Insurance Company v. Harris Trust and Savings Bank*,[143] ruled that certain assets held in an insurance company's general account should be considered plan assets.

Reasons for Change

The Congress believed it appropriate to address the issue of which assets of an insurer constitute plan assets by directing the Secretary of Labor to promulgate regulations and by providing guidance with respect to the content of such regulations.

Explanation of Provision

Under the Small Business Act, the Secretary of Labor is required to issue proposed regulations no later than June 30, 1997, providing guidance for the purpose of determining which assets of an insurer (other than plan assets held in its separate account) constitute plan assets for purposes of ERISA and the Code in cases in which the insurer issues 1 or more policies (supported by the assets of the insurer's general account) to or for the benefit of an employee benefit plan. Such proposed regulations are to be subject to public notice and comment until September 30, 1997, and the Secretary of Labor would be required to issue final regulations by December 31, 1997. Any regulations issued by the Secretary of Labor in accordance with the Act could not take effect before the date on which such regulations became final. Such regulations will only apply with respect to a policy issued by an insurer on or before December 31, 1998. In the case of such a policy, the regulations will take effect at the end of the 18 month period following the date

[141] These requirements are in Part 4 subtitle B, of Title 1 of ERISA.

[142] 29 CFR section 2509.75-2(b) (1992). The term "general account" refers to all assets of an insurance company which are not legally segregated and allocated to separate accounts. The assets in a general account are derived from all classes of business and support the insurers' obligations on an unsegregated basis, with no particular assets being specifically committed to meet the obligations under any particular contract or policy.

[143] 510 U.S. 86 (1993).

such regulations become final. New policies issued after December 31, 1998, will be subject to the fiduciary obligations under ERISA.[144]

In issuing regulations, the Secretary of Labor is to ensure that such regulations are administratively feasible and protect the interests and rights of the plan and of the plan's participants and beneficiaries. In so doing, the Secretary of Labor may exclude any assets of the insurer with respect to its operations, products, or services from treatment as plan assets. Further, the regulations must provide that plan assets do not include assets which are not treated as plan assets under present-law ERISA by reason of being (1) assets of an investment company registered under the Investment Company Act of 1940, and (2) assets of an insurer with respect to a guaranteed benefit policy issued by such insurer.

Under the Small Business Act, in connection with any policy (other than a guaranteed benefit policy) issued by an insurer to or for the benefit of an employee benefit plan, the regulations issued by the Secretary of Labor must require that: (1) a plan fiduciary totally independent of the insurer authorize the purchase of such policy (unless it is the purchase of a life insurance, health insurance, or annuity contract exempt from ERISA's prohibited transaction rules); (2) after the date final regulations are issued the insurer provide periodic reports to the policyholder disclosing the method by which any income or expenses of the insurer's general account are allocated to the policy and disclosing the actual return to the plan under the policy and such other financial information the Secretary may deem appropriate; (3) the insurer disclose to the plan fiduciary the extent to which alternative arrangements supported by assets of separate accounts of the insurer are available, whether there is a right under the policy to transfer funds to a separate account and the terms governing any such right, and the extent to which support by assets of the insurer's general account and support by assets of separate accounts of the insurer might pose differing risks to the plan; and (4) the insurer must manage general account assets with the level of care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, taking into account all obligations supported by such enterprise.

Under the Small Business Act, compliance by the insurer with all the requirements of the regulations issued by the Secretary of Labor is deemed compliance by such insurer with ERISA's fiduciary duties, prohibited transactions, and limitations on holding employer securities and employer real property provisions (ERISA secs. 404, 406, and 407).

Under the Small Business Act, no person is liable under ERISA or the Code for conduct which occurred prior to the date which is 18 months following the effective date of the final regulations on the basis of a claim that the assets of the insurer (other than plan assets held in a separate account) constituted plan assets, except as otherwise provided by the Secretary of Labor in order to prevent

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[144] The term policy includes a contract.

avoidance of the guidance in the regulations or as provided in an action brought by the Secretary of Labor under ERISA's enforcement provisions for a breach of fiduciary responsibility which would also constitute a violation of Federal criminal law or constitute a felony under applicable State law.

The Small Business Act does not preclude the application of any Federal criminal law.

Effective Date

The provision generally is effective on January 1, 1975. However, the provision does not apply to any civil action commenced before November 7, 1995.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts.

23. Church pension plan simplification (secs. 1461-1463 of the Small Business Act and secs. 72(f), 404(a), 414(e), and 414(q) of the Code)

Present and Prior Law

In general, a church plan is a plan established and maintained for employees (or their beneficiaries) by a church or a church convention or association of churches that is exempt from tax (sec. 414(e)). Church plans include plans maintained by an organization, whether a corporation or otherwise, that has as its principal purpose or function the administration or funding of a plan or program for providing retirement or welfare benefits for the employees of the church or convention or association of churches. Employees of a church include any minister, regardless of the source of his or her compensation, and an employee of an organization which is exempt from tax and which is controlled by or associated with a church or a convention or association of churches.[145]

Plans maintained by churches and certain church-controlled organizations are exempt from certain of the requirements applicable to pension plans under the Code pursuant to ERISA. For example, such plans are not subject to ERISA's vesting, coverage, and funding requirements. In some cases, such plans are subject to provisions in effect before the enactment of ERISA. Under the rules in effect before ERISA, a plan cannot discriminate in favor of officers, shareholder, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. Church plans may elect to waive the exemption from the qualification rules (sec. 410(d)). Electing plans become subject to all the tax Code (sec. 401(a)) qualification requirements, Title I of ERISA, and the excise tax on prohibited transactions, and participate in the pension plan termination insurance program administered by the Pension Benefit Guaranty Corporation.

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[145] With respect to certain provisions (e.g., the exemption for church plans from nondiscrimination requirements applicable to tax-sheltered annuities), the more limited definition of church under the employment tax rules applies (secs. 3121(w)(3)(A) and (B)).

Certain eligible employers may maintain tax-sheltered annuity plans (sec. 403(b)). These plans provide tax-deferred retirement savings for employees of public education institutions and employees of certain tax-exempt organizations (including churches and certain organizations associated with churches). In addition to tax-sheltered annuities, alternative funding mechanisms that provide similar tax benefits include church-maintained retirement income accounts (sec. 403(b)(9)).

For purposes of determining an employee's investment in the contract under the rules relating to taxation of annuities, amounts contributed by the employer are included as investment in the contract, but only to the extent that such amounts were includible in the gross income of the employee or, if such amounts had been paid directly to the employee, would not have been includible in income. However, amounts contributed by the employer which, if they had been paid directly to the employee, would have been excludable under section 911 are not treated as investment in the contract, except to the extent attributable to services performed before January 1, 1963.

Reasons for Change

The Congress believed that the unique characteristics of churches compared to other employers, including tax-exempt employers, create particular problems in complying with the many requirements that apply to qualified pension plans. Thus, the Congress found it appropriate to provide certain special rules with respect to such plans.

Explanation of Provisions

The Small Business Act allows self-employed ministers to participate in a church plan. For purposes of the definition of a church plan, a self-employed minister is treated as his or her own employer and as if the employer were a tax-exempt organization under section 501(c)(3). The earned income of the self-employed minister (for services as a minister) is treated as his or her compensation. Self-employed ministers are able to deduct their contributions.

In addition, ministers employed by an organization other than a church are treated as if employed by a church. Thus, such ministers could also participate in a church plan. The Act provides that if a minister is employed by an employer that is not eligible to maintain a church plan, the minister is not taken into account by that employer in applying nondiscrimination rules.

The Small Business Act permits retirement income accounts to be established for self-employed ministers.

The Small Business Act provides that church plans subject to the pre-ERISA nondiscrimination rules apply the same definition of highly compensated employee as other pension plans, rather than the pre-ERISA rule relating to employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees or highly compensated employees.

The Small Business Act provides that the Secretary of the Treasury may develop safe harbor rules for church plans under the applicable coverage and nondiscrimination rules.

The Small Business Act provides that, in the case of foreign missionaries, amounts contributed to a plan by the employer are investment in the contract even though the amounts, if paid directly to the employee, would have been excludable under section 911.

Effective Date

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

Revenue Effect

The provisions are estimated to have a negligible effect on Federal fiscal year budget receipts.

24. Waiver of excise tax on failure to pay liquidity shortfall (sec. 1464 of the Small Business Act and sec. 4971(f) of the Code)

Present and Prior Law

Effective for plan years beginning after December 31, 1994, a provision in the Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreement on Tariffs and Trade ("GATT"), generally requires certain under funded single-employer defined benefit plans to make quarterly contributions sufficient to maintain liquid plan assets, i.e., cash and marketable securities, in an amount approximately equal to three times the total trust disbursements for the preceding 12-month period. This liquidity requirement only applies to underfunded single-employer defined benefit plans (other than small plans)[146] that (1) are required to make quarterly installments of their estimated minimum funding contribution for the plan year, and (2) have a liquidity shortfall for any quarter during the plan year.

A plan has a liquidity shortfall if its liquid assets as of the last day of the quarter are less than the base amount for the quarter. Liquid assets are cash, marketable securities and such other assets as specified by the Secretary. The base amount for the quarter is an amount equal to the product of three times the adjusted disbursements from the plan for the 12 months ending on the last day of the last month preceding the quarterly installment due date. If the base amount exceeds the product of two times the sum of adjusted disbursements for the 36 months ending on the last day of the last month preceding the quarterly installment due date, and an enrolled actuary certifies to the satisfaction of the Secretary that the excess is the result of nonrecurring circumstances, such nonrecurring circumstances are not included in the base amount. For purposes of determining the base amount, adjusted disbursements mean the amount of all disbursements from the plan's trust, including purchases of annuities, payments of single sums, other benefit payments, and administrative expenses reduced by the

[146] A plan is a small plan if it had 100 or fewer participants on each day during the plan year (as determined in Code sec. 412(l)(6)).

product of the plan's funded current liability percentage for the plan year and the sum of the purchases of annuities, payments of single sums, and such other disbursements as the Secretary provides in regulations.

The amount of the required quarterly installment for defined benefit plans that have a liquidity shortfall for any quarter is the greater of the quarterly installment or the liquidity shortfall. The amount of the liquidity shortfall must be paid in the form of liquid assets. It may not be paid by the application of credit balances in the funding standard account. The amount of any liquidity shortfall payment when added to prior installments for the plan year cannot exceed the amount necessary to increase the funded current liability percentage of the plan to 100 percent taking into account the expected increase in current liability due to benefits accruing during the plan year.

If a liquidity shortfall payment is not made, the plan sponsor is subject to a nondeductible excise tax equal to 10 percent of the amount of the outstanding liquidity shortfall. A liquidity shortfall payment will no longer be considered outstanding on the earlier of (1) the last day of a later quarter for which the plan does not have a liquidity shortfall or (2) the date on which the liquidity shortfall for a later quarter is timely paid. If the liquidity shortfall remains outstanding after four quarters, the excise tax increases to 100 percent.

Reasons for Change

The Congress believed it appropriate to give the Secretary of the Treasury the authority to waive the excise with respect to liquidity shortfalls under certain circumstances.

Explanation of Provision

The Small Business Act gives the Secretary of the Treasury authority to waive all or part of the excise tax imposed for a failure to make a liquidity shortfall payment if the plan sponsor establishes to the satisfaction of the Secretary of the Treasury that the liquidity shortfall was due to reasonable cause and not willful neglect and reasonable steps have been taken to remedy such shortfall.

Effective Date

The provision is effective as if included in GATT.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1997, $3 million in 1998, $2 million in 1999, $1 million in 2000, and by less than $500,000 in each of 2001 through 2006.

25. Date for adoption of plan amendments (sec. 1465 of the Small Business Act)

Present Law

Plan amendments to reflect amendments to the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs.

Reasons for Change

The Congress believed that plan sponsors should have adequate time to amend plan documents.

Explanation of Provision

The Small Business Act generally provides that any amendments to a plan or annuity contract required by the pension simplification provisions do not have to be made before the first plan year beginning on or after January 1, 1998. In the case of a governmental plan, the date for amendments is extended to the first plan year beginning on or after January 1, 2000.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to have no revenue effect.

III. FOREIGN SIMPLIFICATION PROVISION

1. Repeal of excess passive assets provision (sec. 1501 of the Small Business Act and section 956A of the Code)

Present and Prior Law

Under the rules of subpart F (secs. 951-964), certain 10-percent U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are actually distributed currently to the shareholders. The 10-percent U.S. shareholders of a CFC are subject to current U.S. tax on their shares of certain income earned by the CFC (referred to as "subpart F income"). The 10-percent U.S. shareholders also are subject to current U.S. tax on their shares of the CFC's earnings to the extent such earnings are invested by the CFC in certain U.S. property.

In addition to these current inclusion rules, the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") enacted section 956A, which applied another current inclusion rule to U.S. shareholders of a CFC. Section 956A required the 10-percent U.S. shareholders of a CFC to include in income currently their shares of the CFC's earnings to the extent such earnings were invested by the CFC in excess passive assets. A CFC generally was treated as having excess passive assets if the average of the amounts of its passive assets exceeded 25 percent of the average of the amounts of its total assets; this calculation required a quarterly determination of the CFC's passive assets and total assets.

Reasons for Change

The Congress believed that, with the enactment of section 956A, the 1993 Act added an additional layer of complexity to the subpart F rules. In addition to determining the current inclusions with respect to a CFC's subpart F income and earnings invested in U.S. property, the U.S. shareholders also had to determine the current inclusion with respect to the CFC's earnings invested in excess passive assets. Application of section 956A required determination and measurement of the CFC's passive assets and total assets on a quarterly basis. The Congress understood that compliance with section 956A imposed substantial administrative burdens on both taxpayers and the IRS.

The Congress also understood that section 956A was enacted in order to restrict the benefits of tax deferral for CFCs that accumulate passive assets abroad. However, the Congress further understood that the rules of section 956A operated to provide incentives for CFCs to make investments, enter into transactions, and engage in reorganizations for the purpose of avoiding the application of such section. The Congress was informed that CFCs acquired for-

eign assets that would not otherwise be attractive investments if such acquisitions reduced the CFC's percentage of passive assets below the threshold for application of section 956A. The Congress was further informed that some U.S. shareholders of CFCs viewed section 956A as having the effect of an investment tax credit for foreign investments by CFCs. For example, consider a U.S. shareholder that owns a CFC with $30 of passive assets and $100 of total assets. The U.S. shareholder could avoid a current inclusion under section 956A by having the CFC reduce its passive assets so that its ratio of passive assets to total assets fell to 25% or less. This could be accomplished by having the CFC distribute $7 of its passive assets to the U.S. shareholder. However, it also could be accomplished by having the CFC invest $5 of its passive assets in active foreign assets. Moreover, the U.S. shareholder could reduce the CFC's ratio of passive assets to total assets and avoid a current inclusion under section 956A by contributing $20 to the CFC which the CFC uses to make an investment in $20 of additional active foreign assets.

The Congress was concerned that section 956A provided taxpayers with incentives to engage in costly, non-economic transactions. The Congress was further concerned that section 956A provided incentives for taxpayers to make investments outside the United States that might otherwise be made in the United States. The Congress believed that the administrative burdens of compliance coupled with the costs associated with transactions undertaken to avoid its application call into question the appropriateness of section 956A.

Explanation of Provision

The Small Business Act repeals section 956A.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1996, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $11 million in 1997, $22 million in 1998, $29 million in 1999, $36 million in 2000, $41 million in 2001, $45 million in 2002, $51 million in 2003, $57 million in 2004, $64 million in 2005, and $71 million in 2006.

IV. OTHER PROVISIONS

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

Present and Prior Law

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

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

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

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA. The State of Alaska generally was exempted from the Clean Air Act, but not the excise tax, dyeing regime for three years (until October 1, 1996, or such later date established by the U.S. Environmental Protection Agency) (urban areas) or permanently (remote areas).

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1997, and by $1 million in each of 1998 through 2006.

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

Prior Law

In general, the OASDI portion of FICA taxes are payable with respect to employee remuneration not in excess of a contribution base. If an employee works for more than one employer during a year, these taxes are payable by each employer up to the contribution base. Under the common paymaster rule if an individual works for two or more related corporations, the remuneration may be treated as being from one employer and therefor taxable for one contribution base.

Section 125 of Social Security Amendments of 1983 provided a common paymaster rule for certain State universities that employ health care professionals as faculty members at a medical school and at a tax-exempt faculty practice plan. This rule does not explicitly apply to situations where compensation is made through a university agency account and not directly by a medical school faculty practice plan.

Reasons for Change

The Congress believed that the application of the common paymaster rule is appropriate in the foregoing circumstances where such compensation is made through a university agency account.

Explanation of Provision

The Small Business Act establishes a common paymaster rule in cases where: (1) a State or State university provides remuneration pursuant to a single contract of employment to certain health care professionals as members of its medical school faculty; and (2) an agency account at such institution also provides remuneration to such health care professionals. The agency account must receive

funds for the remuneration from a faculty practice plan described in section 501(c)(3) of the Code. The payments may only be distributed by the agency account to faculty members who render patient care at the medical school. The faculty members receiving payments must comprise at least 30 percent of the membership of the faculty practice plan.

Effective Date

The provision is effective for remuneration paid after December 31, 1996.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year.

3. Modifications to excise tax on ozone-depleting chemicals

a. Exempt imported recycled halons from the excise tax on ozone-depleting chemicals (sec. 1803(a) of the Small Business Act and sec. 4282 of the Code)

Present and Prior Law

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

Taxable chemicals that are recovered and recycled within the United States are exempt from tax (sec. 4682(d)(1)).

Reasons for Change

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

Explanation of Provision

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

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

Effective Date

The provision is effective for halon-1301 and halon-2402 imported after December 31, 1996, and for halon-1211 imported after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million per year, beginning with fiscal year 1997.

b. Exempt chemicals used in metered-dose inhalers from the excise tax on ozone-depleting chemicals (sec. 1803(b) of the Small Business Act and sec. 4282 of the Code)

Present and Prior Law

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

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

The provision is effective for chemicals sold or used seven days after the date of enactment (on or after August 27, 1996).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $12 million in fiscal 1997, $8 million in fiscal 1998, $8 million in fiscal 1999, and $2 million in fiscal 2000.

4. Tax-exempt bonds for the sale of Alaska Power Administration facility (sec. 1804 of the Small Business Act)

Prior Law

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

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

Reasons for Change

Limited tax-exempt financing is an integral component of recently enacted legislation authorizing the sale of certain existing facilities by the Alaska Power Administration. The Congress determined that a limited exception to the rehabilitation requirement of the tax-exempt bond rules is appropriate to facilitate completion of this unique transaction.

Explanation of Provision

The Small Business Act provides an exception from the general rehabilitation requirement for private activity bonds used to finance the acquisition of the Snettisham hydroelectric project from the Alaska Power Administration pursuant to the legislation authorizing that transaction. Bonds for this acquisition will be subject to the State of Alaska's private activity bond volume limit.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million per year during the period 1997 through 2006. The asset sale involved in the underlying transaction is estimated to increase Federal fiscal year budget receipts by $76 million in 1997 and to reduce those receipts by $7 million annually during the period 1998 through 2006.

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

Prior Law

Common trust funds

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

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

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

Regulated investment companies ("RICs")

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

Reasons for Change

The Congress understood that administrative costs of managing pools of assets can be reduced for many banks if the bank utilizes the expertise of professional investment managers employed at mutual funds rather than attempting to duplicate the same investment management services within the bank. The Congress further recognized that generally both common trust funds and mutual funds seek broad diversification of the assets contributed by the in-

vestors in the common trust fund or the mutual fund. Because both the common trust fund and the mutual fund are conduit entities for Federal income tax purposes, the Congress believed that it would be inappropriate to impose a tax when the common trust fund transfers substantially all of its assets to one or more RICs, because only the form of the investment pool has been changed.

Explanation of Provision

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

The basis of any asset received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. If stock in more than one RIC is received in exchange for assets of a common trust fund, the basis of the shares in each RIC is determined by allocating the basis of common fund assets used in the exchange among the shares of each RIC received in the exchange on the basis of the respective fair market values of the RICs.

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

Effective Date

The provision is effective for transfers after December 31, 1995. In order to qualify for the provision, the transfer by the common trust fund to the RIC must occur after December 31, 1995. The Congress intended that there is no requirement for qualification that the transfer of assets by the common trust fund to one or more RICs and the distribution of RIC shares to participants in the common trust fund be made contemporaneously or pursuant to a single plan.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1996, $9 million 1997, $8 million in 1998 through 2002, and $9 million in each of 2003 through 2006.

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

Prior Law

In *Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994), the Sixth Circuit held that the Michigan Education Trust, an entity created by the State of Michigan to operate a prepaid tuition payment program, is an integral part of the State, and, thus, the investment income realized by the Trust is not currently subject to Federal income tax. The Trust was established to receive advance payments of college tuition, invest the money, and ultimately make disbursements under a program that allows beneficiaries to attend any of the State's public colleges or universities without further tuition costs for a year or more (depending on the terms of the contract).

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

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

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

Reasons for Change

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

Explanation of Provision

The Small Business Act provides tax-exempt status to "qualified State tuition programs," meaning programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified

higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). The Small Business Act specifically provides that, although a qualified State tuition program generally is exempt from Federal income tax, such a program is subject to the unrelated business income tax (UBIT).[147]

A qualified State tuition program is required to provide that purchases or contributions may only be made in cash. A qualified State tuition program must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. Contributors and beneficiaries are not allowed to direct any investments made on their behalf by the program. The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program[148]), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program) unless the new beneficiary is a member of the family of the old beneficiary.[149] Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary[150] , or (3) made on account of a scholarship (or allowance or payment described in section 135(d)(1)(B) or (C)) received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship, allowance, or payment. A qualified State tuition program may not allow any interest in the program or any portion thereof to be used as security for a loan.

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[147] The Small Business Act specifically provides that an interest in a qualified State tuition program will not be treated as debt for purposes of the UBIT debt-financed property rules (sec. 514). Consequently, a qualified State tuition program's investment income will not constitute debt-financed property income subject to the UBIT merely because the program accepts contributions and is obligated to pay out (or refund) such contributions and certain earnings thereon to designated beneficiaries or to contributors. However, investment income of a qualified State tuition program could be subject to the UBIT as debt-financed property income to the extent the program acquires indebtedness when investing the contributions made on behalf of designated beneficiaries.

[148] The Small Business Act allows for a change in designated beneficiaries, so long as the new beneficiary is a member of the family of the old beneficiary.

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

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

In addition, the Small Business Act provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent or other relative receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[151] The Congress expressed its understanding that if matching-grant amounts are distributed to (or on behalf of) a beneficiary as part of a qualified State tuition program, then such matching-grant amounts still may be excluded from the gross income of the beneficiary as a scholarship under present-law section 117.

Contributions made to a qualified State tuition program will be treated as incomplete gifts for Federal gift tax purposes. Thus, any Federal gift tax consequences will be determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program will be treated as a qualified transfer for purposes of present-law section 2503(e).[152] Amounts contributed to a qualified State tuition program (and earnings thereon) will be included in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program.

Effective Date

The provision is effective for taxable years ending after the date of enactment. The Small Business Act also includes a transition rule providing that if (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after the date of enactment, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after the date of enactment, then the provisions of the Small Business Act will apply to contributions (and earnings allocable thereto) made before the date the program meets the requirements of a qualified State tuition program, with-

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

[152] In this regard, the Congress intended that if a qualified State tuition program issues a check in the names of both the designated beneficiary and an educational institution at which the beneficiary incurs (or will incur) qualified higher education expenses, then the issuance of the check will be considered a payment of qualified higher education expenses to an educational institution if the check (after endorsement by the beneficiary) is deposited in the institution's bank account.

out regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).[153]

Revenue Effect

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts.

7. Tax credit and exclusion for adoption expenses (sec. 1807 of the Small Business Act and new secs. 23 and 137 of the Code)

Present and Prior Law

Under present law, the Federal Adoption Assistance program (a Federal outlay program) provides financial assistance for the adoption of certain special needs children. In general, a special needs child is defined as a child who (1) according to a State determination, could not or should not be returned to the home of the birth parents and (2) on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental or emotional handicap), could not reasonably be expected to be adopted unless adoption assistance is provided. Specifically, the program provides assistance for adoption expenses for those special needs children receiving Federally assisted adoption assistance payments as well as special needs children in private and State-funded programs. The maximum Federal reimbursement is $1,000 per special needs child. Reimbursable expenses include those nonrecurring costs directly associated with the adoption process such as legal costs, social service review, and transportation costs.

Prior law provided no specific Federal tax benefits to encourage adoption.

Reason for Change

The Congress believed that the financial costs of the adoption process should not be a barrier to adoption. In addition, the Congress wished to encourage further the adoption of special needs children, as defined under present law section 473(c) of the Social Security Act. Therefore in the case of domestic special needs adoptions, the maximum tax credit was increased from $5,000 to $6,000, and was not made subject to the sunset. Similarly, the allowable exclusion under an employer adoption assistance program was increased from $5,000 to $6,000 in the case of a domestic special needs adoption.

[153] A technical correction may be necessary to clarify that the transition rule covers contributions (and earnings allocable thereto) made *after* the date a State program comes into compliance with the requirements of a qualified State tuition program if such contributions are made pursuant to a contract entered into *before* the date the program comes into compliance with the requirements of a qualified State tuition program. Moreover, the IRS is encouraged to administer general rules under prior law to achieve a result consistent with such a clarification of the Small Business Act's transition rule in cases where contributions (i.e., installment payments) are made pursuant to a contract entered into before the date a State program meets the requirements of a qualified State tuition program.

The Congress believed that encouraging adoptions in an efficient manner requires a continuous effort to improve the delivery of Federal subsidies. For this reason, the Congress believed that a Treasury Department study is necessary to determine whether the adoption credit and exclusion are an efficient Federal subsidy.

Explanation of Provision

Tax credit

The Small Business Act provides taxpayers with a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid (in the case of a cash basis taxpayer) or incurred (in the case of an accrual basis taxpayer) by the taxpayer. In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). A special needs child is a child who the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance.[154] Examples of factors or conditions are the child's ethnic background, age, membership in a minority or sibling group, medical conditions, or physical, mental, or emotional handicaps. The Small Business Act provides that to the extent the otherwise allowable credit exceeds the tax liability limitation of section 26 (reduced by other personal credits) the excess shall be carried forward as an adoption credit into the next taxable year, up to a maximum of five taxable years.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. For example, expenses may include the cost of construction, renovations, alterations or purchases specifically required by the State to meet the needs of the child. In the case of an adoption of a child who is not a citizen or a resident of the United States (foreign adoption), the credit is not available unless the adoption is finalized. In the case of otherwise qualified expenses that are incurred in an adoption that is not yet identified as either a domestic or a foreign adoption, the credit would not be available until the expenses are identified as either relating to a domestic adoption (whether or not finalized) or to a finalized foreign adoption. In some instances that may require the filing of an amended tax return.

An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for himself or herself. After December 31, 2001, the credit will be available only for domestic special needs adoptions. No credit is allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, (3) in connection with the adoption of a child of the taxpayer's spouse, or (4) that are reimbursed under an employer adoption assistance program or otherwise.

[154] After December 31, 2001, for purposes of the credit only domestic special needs adoptions will qualify as special needs adoptions.

The credit is phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

The $5,000 limit is a per child limit, not an annual limitation. For example, if in the case of an attempt to adopt a child a taxpayer pays or incurs $3,000 of qualified adoption expenses in year one and $3,000 of qualified adoption expenses in year two, then the taxpayer would receive $5,000 not $6,000 of credit. To illustrate further, if a taxpayer pays or incurs $1,000 of otherwise qualified adoption expenses at each of three agencies in unsuccessful attempts to adopt a child before paying or incurring $4,000 of otherwise qualified adoption expenses in a successful domestic adoption, the taxpayer's maximum adoption credit is $5,000, not $7,000. The credit may be less than $5,000 because of other limitations. It is also intended that when more than one taxpayer (e.g., more than one unmarried individual) who are parties to an adoption pays or incurs qualified adoption expenses for the adoption of the same child, the total adoption credit claimed by all parties shall not exceed $5,000.

Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final. To illustrate this rule, consider again the example of a taxpayer who pays or incurs $3,000 of qualified adoption expenses in year one and $3,000 of qualified adoption expenses in year two for a domestic adoption. Assume the adoption is not finalized until year three. Under this general rule, the $3,000 of qualified expenses paid or incurred in year one would be allowed in year two and $2,000 of the $3,000 paid or incurred in year two would be allowed in year three. Alternatively, if the adoption was finalized in year two, then $5,000 of qualified expenses would be allowed in year two.

To avoid a double benefit, the Small Business Act denies the credit to taxpayers to the extent the taxpayer may use otherwise qualified adoption expenses as the basis of another credit or deduction. Similarly, the credit is not allowed for any expenses for which a grant is received under any Federal, State, or local program. This denial of the credit also applies in the case of special needs adoptions. Also, when the adoption credit is allowed because the taxpayer expends amounts chargeable to a capital account (e.g., the costs of constructing a ramp at the taxpayer's house to accommodate a wheelchair that is required as a condition of the adoption), the taxpayer is not allowed additional basis in the house to the extent of the adoption credit allowed. Where the amount of qualified adoption expenses exceeds $5,000, (e.g., $5,000 of legal fees and $5,000 of ramp construction costs) it is intended that the amounts not chargeable to a capital account (the legal fees) are treated as the basis of the credit before any amounts that are chargeable to a capital account. In this way, for example, the taxpayer may sat-

isfy the requirements of the adoption credit with the legal fees and may add the ramp construction costs to the basis in the house.

The Small Business Act provides that individuals who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart from each other for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the child for more than one-half of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Further, the Small Business Act provides that an individual legally separated from his or her spouse under a decree of divorce or separate maintenance is not considered married for purposes of this provision.

Exclusion from income

The Small Business Act provides a maximum $5,000 exclusion from the gross income of an employee for qualified adoption expenses (as defined above) paid by the employer.[155] The $5,000 limit is a per child limit, not an annual limitation. In the case of a special needs adoption, the maximum exclusion from income is $6,000 ($5,000 in the case of foreign special needs adoptions). No exclusion is allowed for amounts paid or incurred by an employer after December 31, 2001. In order for the exclusion to apply, the expenses would have to be paid under an adoption assistance program in connection with an adoption of an eligible child (as described above) by an employee.

An adoption assistance program is a nondiscriminatory plan of an employer under which the employer provides employees with adoption assistance. Also, not more than 5 percent of the benefits under the program for any year may benefit a class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. An adoption assistance program is not required to be funded but must provide reasonable notification of the availability and terms of the program to eligible employees. An adoption reimbursement program operated under section 1052 of title 10 of the U.S. Code (relating to the armed forces) or section 514 of title 14 of the U.S. Code (relating to members of the Coast Guard) is treated as an adoption assistance program for these purposes. Adoption assistance is a qualified benefit under a cafeteria plan. The exclusion is phased out ratably for taxpayers with modified AGI above $75,000 and is fully phased out at $115,000 of modified AGI (in the same manner as the adoption credit[156]). Adoption expenses paid or reimbursed under an adoption assistance program may not be taken into account in determining the adoption credit. A taxpayer may, however, satisfy the requirements of the adoption credit and exclusion with different expenses paid or incurred by the taxpayer and employer respectively. For example in the case of an adoption that costs $10,000 with $5,000 of expenses paid by the taxpayer and $5,000 paid by the taxpayer's employer under an adoption assistance program the taxpayer may qualify for the adoption credit and

[155] The Small Business Act does not include a payroll tax exclusion for these amounts.

[156] A technical correction may be needed so that the statute reflects this intent.

the exclusion. The Congress expects that these provisions will be administered (pursuant to the Commissioner's regulatory authority) so that withholding from the taxpayer's wages approximates as closely as possible the taxpayer's ultimate tax liability.

Under the Small Business Act, the Secretary of the Treasury has the authority to issue regulations to carry out these provisions, including regulations treating unmarried individuals who pay or incur qualified adoption expenses with respect to the same child as one taxpayer for purposes of applying the dollar limitations. In the case of amounts paid or expenses incurred under an adoption assistance program that may otherwise be chargeable to a capital account, an ordering rule similar to the one for the adoption credit applies.

Taxpayer identification numbers (TINS)

The Congress was concerned that problems may arise in processing tax returns of adopting parents because of unavoidable delays involved in obtaining a social security number of a child who is being adopted. The Congress understood that the Internal Revenue Service recognizes these concerns and is committed to working with the Congress to develop as soon as possible an administrative solution that minimizes the burdens imposed on adopting parents while balancing processing and potential compliance considerations.

A taxpayer is, however, required to provide information about the name, age and TIN of each adopted child for both the tax credit and exclusion where such information is known to the taxpayer. The Secretary of the Treasury may also require other information to improve compliance with these sections, (e.g., identification of the agent, if any, assisting with the adoption).

Treasury study

The Secretary of the Treasury is directed to prepare a study of the effects of the tax credit and exclusion on both non-special needs adoptions and special needs adoptions, to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance by January 1, 2000.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $19 million in 1997, $204 million in 1998, $332 million in 1999, $355 million in 2000, $366 million in 2001, $348 million in 2002, $222 million in 2003, $139 million in 2004, $129 million in 2005, and $119 million in 2006.

8. Six-month delay in implementation of electronic fund transfer system for collection of certain taxes (sec. 1809 of the Small Business Act)

Present and Prior Law

Employers are required to withhold income taxes and FICA taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code sec. 6302(h)). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[157] Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors. Under prior law, Treasury had implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997.

Reasons for Change

The Congress was concerned that the initial mailing by IRS to employers that informed them of the 1997 requirements confused many of these employers. The Congress believed that it was necessary to provide additional time prior to implementation of the 1997 requirements so that employers may be better informed about their responsibilities.

Explanation of Provision

The Small Business Act provides that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) shall not take effect until July 1, 1997.

Effective Date.

The provision is effective on the date of enactment.

[157] Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently becoming operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

V. REVENUE OFFSETS

1. Modifications of the Puerto Rico and possession tax credit (sec. 1601 of the Small Business Act and section 936 and new section 30A of the Code)

Prior Law

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

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

A domestic corporation that has elected the Puerto Rico and possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualifying wage and fringe benefit expenses, (2) specified percentages of the taxpayer's depreciation allowances with respect to qualifying tangible property, and (3) in certain cases, the taxpayer's qualifying possession income taxes. The credit calculated under the economic activity limit is referred to herein as the "wage credit." In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the

applicable percentage is phased down to 50 percent for 1996, 45 percent for 1997, and 40 percent for 1998 and thereafter. The credit calculated under the applicable percentage limit is referred to herein as the "income credit." The amount of the Puerto Rico and possession tax credit attributable to QPSII is not subject to these limitations.

Reasons for Change

The Congress understood that the tax benefits provided by the Puerto Rico and possession tax credit are enjoyed by only the relatively small number of U.S. corporations that operate in the possessions. Moreover, the Congress was concerned about the tax cost of the benefits provided to these possession corporations that is borne by all U.S. taxpayers. In light of current budget constraints, the Congress believed that the continuation of the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit was no longer appropriate. However, the Congress believed that an appropriate transition period should be provided for corporations that have existing operations in the possessions. Moreover, the Congress believed that the credit computed under the economic activity limit for Puerto Rico should be moved to a new section of the Code contained in a subpart that includes other business-type credits; the credit computed under the economic activity limit operates as a credit in the traditional sense, measured by the level of employment and other economic activity engaged in by the taxpayer in the possession.

Explanation of Provision

In general

The provision generally repeals the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the provision provides grandfather rules under which a corporation that is an existing credit claimant is eligible to claim credits for a transition period. A special transition rule applies to the credit attributable to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

For taxable years beginning after December 31, 1995, the Puerto Rico and possession tax credit applies only to a corporation that qualifies as an existing credit claimant (as defined below). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A corporation that is an existing credit claimant with respect to a possession is entitled to the credit for income from such possession for taxable years beginning after December 31, 1995, subject to the limitations described below. The credit, subject to such limitations, is computed separately for each possession with respect to which the corporation is an existing credit claimant. The computation of the Puerto Rico and possession tax credit attributable to possession business income during the grandfather period depends upon whether the corporation is using the economic activity limit or the applicable percentage limit.

Credit attributable to QPSII

The provision generally eliminates the Puerto Rico and possession tax credit attributable to QPSII for taxable years beginning after December 31, 1995. However, the provision continues to allow the credit attributable to QPSII for QPSII earned before July 1, 1996. The Congress noted that the repeal of the credit for QPSII will have the effect of eliminating a provision that has supported economic development and trade-related growth in the Caribbean Basin and served U.S. interests in the region. The Congress further noted that the loss of this program should not be interpreted as a loss of U.S. interest in the region. The Congress expressed its continued support for efforts furthering stable commercial and economic relations in that region.

Wage credit

For corporations that are existing credit claimants with respect to a possession and that use the wage credit method, the possession tax credit attributable to business income from the possession (determined under the wage credit method) continues to be determined as under section 936 prior to the enactment of the Small Business Act for taxable years beginning after December 31, 1995 and before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the wage credit is subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the wage credit method) is eliminated.

The provision adds to the Code section 30A which provides a credit determined under the wage credit method for business income from Puerto Rico. Such credit is computed under the rules described above with respect to the possession tax credit determined under the wage credit method. Such section applies for taxable years beginning after December 31, 1995 and before January 1, 2006.

Income credit

For corporations that are existing credit claimants with respect to a possession and that elected to use the income credit method and not to use the wage credit method, the Puerto Rico and possession tax credit attributable to business income from the possession continues to be determined as under section 936 prior to the enactment of the Small Business Act for taxable years beginning after December 31, 1995 and before January 1, 1998. For taxable years beginning after December 31, 1997 and before January 1, 2006, the corporation's possession business income that is eligible for the income credit is subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the income credit method) is eliminated.

A corporation that had elected to use the income credit method is permitted to revoke that election under present law. Under the provision, such a revocation is required to be made not later than with respect to the first taxable year beginning after December 31,

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1996; such revocation, if made, applies to such taxable year and to all subsequent taxable years. Accordingly, a corporation that had an election in effect to use the income credit method could revoke such election effective for its taxable year beginning in 1997 and thereafter; such corporation would continue to use the income credit method for its taxable year beginning in 1996 and would use the wage credit method for its taxable year beginning in 1997 and thereafter.

Computation of income cap

The cap on a corporation's possession business income that is eligible for the Puerto Rico and possession tax credit is computed based on the corporation's possession business income for the base period years ("average adjusted base period possession business income"). Average adjusted base period possession business income is the average of the adjusted possession business income for each of the corporation's base period years. For the purpose of this computation, the corporation's possession business income for a base period year is adjusted by an inflation factor that reflects inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor is increased by 5 percentage points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995. Adjustments to the corporation's average adjusted base period possession business income to reflect acquisitions or dispositions shall be made under rules similar to the rules of section 41(f)(3). Under section 41(f)(3), adjustments are made upon the acquisition or disposition of the major portion of a trade or business or the major portion of a separate unit of a trade or business.

The corporation's base period years generally are three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income are taken into account. A corporation is considered to have significant possession business income for a taxable year if such income exceeds two percent of the corporation's possession business income for the each of the six taxable years ending with the first taxable year ending on or after October 14, 1995. If the corporation has significant possession business income for only four of the five most recent taxable years ending before October 14, 1995, the base period years are determined by disregarding the year in which the corporation's possession business income was lowest. If the corporation has significant possession business income for three years or fewer of such five years, then the base period years are all such years. If there is no year of such five taxable years in which the corporation has significant possession business income, then the corporation is permitted to use as its base period its first taxable year ending on or after October 14, 1995; for this purpose, the amount of possession business income taken into account is the annualized amount of such income for the portion of the year ended September 30, 1995.

As one alternative, the corporation may elect to use its taxable year ending in 1992 as its base period (with the adjusted posses-

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

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

Qualification as existing credit claimant

A corporation is an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995.

Under the provision, a corporation will qualify as an existing credit claimant if it acquires all the assets of a trade or business of a corporation that actively conducted such trade or business in a possession on October 13, 1995 and had elected the benefits of the Puerto Rico and possession tax credit pursuant to an election in effect for its taxable year that includes October 13, 1995. The adjusted base period income of the existing credit claimant from which the assets are acquired is divided between such corporation and the corporation that acquires such assets. It is intended that regulations or other guidance will prevent taxpayers from abusing this rule through transactions that manipulate base period income amounts.

For purposes of these rules, a corporation is treated as engaged in the active conduct of a trade or business within a possession on October 13, 1995, if such corporation was engaged in the active conduct of such trade or business before January 1, 1996, and such corporation had in effect on October 13, 1995, a binding contract for the acquisition of assets to be used in, or the sale of property to be produced in, such trade or business. For example, if a corporation had in effect on October 13, 1995, binding contracts for the lease of a facility and the purchase of machinery to be used in a manufacturing business in a possession and if the corporation began actively conducting that manufacturing business in the possession before January 1, 1996, that corporation would be an existing credit claimant. A change in the ownership of a corporation will not affect its status as an existing credit claimant.

A corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) after October 13, 1995, ceases

to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added.

In determining whether a corporation has added a substantial new line of business, the Congress intended that principles similar to those reflected in Treasury Regulation section 1.7704-2(c) and (d) (relating to the transition rules for existing publicly traded partnerships) apply. All eight factors which Treas. Reg. section 1.7704-2(d)(3) indicates help to establish the absence for a new line of business will be considered. For example, a corporation in any industry that modifies its current production methods, expands existing facilities, or adds new facilities to support the production of its current product lines and products within the same four-digit Industry Number Standard Industrial Classification Code (Industry SIC Code) will not be considered to have added a substantial new line of business. In this regard, the Congress intended that the fact that a business which is added is assigned a different four-digit Industry SIC Code than is assigned to an existing business of the corporation will not automatically cause the corporation (regardless of the industry the corporation is in) to be considered to have added a new line of business. For example, a pharmaceutical corporation that begins manufacturing a new drug will not be considered to have added a new line of business. Moreover, as another example, a pharmaceutical corporation that begins to manufacture a complete product from the bulk active chemical through the finished dosage form, a process that may be assigned two separate four-digit Industry SIC Codes, will not be considered to have added a new line of business even though it was previously engaged in activities that involved only a portion of the entire manufacturing process from bulk chemicals to finished dosages. Similarly, the addition of research and development activities not previously conducted by the corporation also generally will not be considered to be the addition of a new line of business, provided that the research and development activities are related to an existing business. The Congress further intended that, in the case of a merger of affiliated possession corporations that are existing credit claimants, the corporation that survives the merger will not be considered to have added a substantial new line of business by reason of its operation of the existing business of the affiliate that was merged into it.

Special rules for certain possessions

A special transition rule applies to the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. For any taxable year beginning after December 31, 1995, and before January 1, 2006, a corporation that is an existing credit claimant with respect to one of these possessions for such year continues to determine its credit with respect to operations in such possession as under section 936 prior to the enactment of the Small Business Act. For taxable years beginning in 2006 and thereafter, the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands is eliminated.

Special rule for estimated tax payments

Under the provision, for purposes of estimated tax payments due after August 20, 1996 (the date of enactment of the Small Business Act) and before October 1, 1996, a taxpayer whose tax liability is increased by reason of the Small Business Act's modifications of the Puerto Rico and possession tax credit is not required to make a deposit with respect to more than 50 percent of such increase. Any reduction in such payment by reason of this rule will be required to be deposited, without penalty or interest, by the next estimated tax payment due date.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $111 million in 1996, $697 million in 1997, $586 million in 1998, $589 million in 1999, $490 million in 2000, $507 million in 2001, $736 million in 2002, $1,105 million in 2003, $1,378 million in 2004, $1,678 million in 2005, and $2,686 million in 2006.

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

Prior Law

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

Reasons for Change

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

Explanation of Provision

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

Effective Date

The provision is effective with respect to loans made after the date of enactment (August 20, 1996), other than loans made pursuant to a written binding contract in effect before June 10, 1996, and at all times thereafter before such loan is made. The repeal of the 50-percent interest exclusion does not apply to the refinancing of an ESOP loan originally made on or before August 20, 1996, or pursuant to a written binding contract in effect before June 10, 1996, provided: (1) such refinancing loan otherwise meets the requirements of section 133 in effect on August 19, 1996; (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $10 million in 1996, $64 million in 1997, $105 million in 1998, $144 million in 1999, $182 million in 2000, $220 million in 2001, $256 million in 2002, $292 million in 2003, $327 million in 2004, $360 million in 2005, and $327 million in 2006.

3. Apply look-through rule for purposes of characterizing certain subpart F insurance income as unrelated business taxable income (sec. 1603 of the Small Business Act and section 512 of the Code)

Present and Prior Law

An organization that is exempt from tax by reason of Code section 501(a) (e.g., a charity, business league, or qualified pension trust) is nonetheless subject to tax on its unrelated business taxable income (UBTI) (sec. 511). Unrelated business taxable income generally excludes dividend income (sec. 512(b)(1)).

Special rules apply to a tax-exempt organization described in section 501(c)(3) or (c)(4) (i.e., a charity or social welfare organization) that is engaged in commercial-type insurance activities. Such activities are treated as an unrelated trade or business and the tax-exempt organization is subject to tax on the income from such insurance activities (including investment income that might otherwise be excluded from the definition of unrelated business taxable income) under subchapter L (sec. 501(m)(2)).[158] Accordingly, a tax-exempt organization described in section 501(c)(3) or (c)(4) generally is subject to tax on its income from commercial-type insurance activities in the same manner as a taxable insurance company.

A tax-exempt organization that conducts insurance activities through a foreign corporation is not subject to U.S. tax with respect to such activities. Under the subpart F rules, the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation (CFC) are required to include in income currently their shares of certain income of the CFC, whether or not such income

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[158] If the commercial-type insurance activities constitute a substantial part of the organization's activities, the organization will not be tax-exempt under section 501(c)(3) or (c)(4) (sec. 501(m)(1)).

is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC (sec. 953). However, income inclusions under subpart F have been characterized as dividends for unrelated business income tax purposes.[159] Accordingly, insurance income earned by the CFC that is includible in income currently under subpart F by the taxable United States shareholders of the CFC was excluded from unrelated business taxable income in the case of a shareholder that is a tax-exempt organization.

Reasons for Change

The Congress understood that the unrelated business income tax rules are designed to prevent unfair competition by business operations that would otherwise be tax-favored due to their ownership by tax-exempt organizations. The Congress further understood that the rules applicable to certain tax-exempt organizations that conduct insurance activities directly are designed to ensure that such operations are taxed in the same manner as they would be taxed if conducted by a taxable entity. However, the Congress was concerned that the law did not prevent unfair competition where operations involving the insurance of third-party risks were not conducted directly by such a tax-exempt organization itself, but were conducted by the organization through a controlled foreign corporation that is subject to little tax relative to competing U.S. businesses.

Explanation of Provision

The Small Business Act applies a look-through rule in characterizing certain subpart F insurance income for unrelated business income tax purposes. Under the Small Business Act, the look-through rule applies to amounts that constitute insurance income currently includible in gross income under the subpart F rules and that are not attributable to the insurance of risks of (1) the tax-exempt organization itself, (2) certain tax-exempt affiliates of such organization, or (3) an officer or director of, or an individual who (directly or indirectly) performs services for, the tax-exempt organization (or certain tax-exempt affiliates) provided that the insurance covers primarily risks associated with the individual's performance of services in connection with the tax-exempt organization (or tax-exempt affiliates). An individual who performs services for a tax-exempt organization through a partnership, for example, is indirectly

[159] The Internal Revenue Service has concluded in private letter rulings, which are not to be used or cited as precedent, that subpart F inclusions are treated as dividends received by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTRs 9407007 (November 12, 1993), 9027051 (April 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), 8819034 (February 10, 1988)). However, the IRS issued one private ruling in which it concluded that subpart F inclusions are treated as if the underlying income were realized directly by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTR 9043039 (July 30, 1990)). This ruling gave no explanation for the IRS's departure from the position in its prior rulings, and the IRS reiterated in a subsequent ruling the position that subpart F inclusions are characterized as dividends for purposes of computing UBTI. Moreover, the application of the look-through rule in the ruling in question did not affect the ultimate result in the ruling because the income to which the subpart F inclusion was attributable was of a type that was excludible from UBTI. The Congress believed that LTR 9043039 (July 30, 1990) is incorrect in its application of a look-through rule in characterizing income inclusions under subpart F for unrelated business income tax purposes.

performing services for such organization. The Congress intended that the determination of whether insurance covers primarily risks associated with the performance of services in connection with the tax-exempt organization or its tax-exempt affiliates will be based on all the facts and circumstances. The Congress further intended that a safe harbor be provided under which this "primarily" requirement will be considered to be satisfied where at least 80 percent of the services covered by the insurance are performed by the insured individual in connection with the tax-exempt organization or its tax-exempt affiliates. For purposes of determining whether the insurance covers risks associated with the individual's performance of services in connection with the tax-exempt organization, the Congress intended that the individual will not be considered to have performed services in connection with a tax-exempt organization solely by reason of the fact that the individual performs services at a facility leased to the individual by the tax-exempt organization.

For purposes of this provision, a tax-exempt organization generally is an affiliate of another tax-exempt organization if (1) the two organizations have significant common purposes and substantial common membership or (2) the two organizations have directly or indirectly substantial common direction or control. In addition, for purposes of the provision, two or more organizations (and any affiliates of such organizations) are treated as affiliates if such organizations are colleges or universities described in section 170(b)(1)(A)(ii) or hospitals or other medical entities described in section 170(b)(1)(A)(iii) and such organizations participate in an insurance arrangement that provides for any profits from such arrangement, when returned, to be returned to the policyholders in their capacity as such. Under this rule, two hospitals could qualify as affiliates of each other, two universities could qualify as affiliates of each other, and a hospital and a university could qualify as affiliates of each other. In applying the provision to two or more tax-exempt organizations that qualify as affiliates and that are the shareholders of a CFC, the exceptions from the look-through rule apply to each such shareholder's share of the income attributable to insurance of risks of all such shareholders; the look-through rule applies to a shareholder's share of any income attributable to insurance of risks of others that are not tax-exempt affiliates of the shareholder.

The specified exceptions from the look-through rule apply on a shareholder by shareholder basis. Accordingly, if the subpart F insurance income allocable to a tax-exempt organization includes both income attributable to the insurance of risks of the organization itself and income attributable to the insurance of risks of another shareholder that is not a tax-exempt affiliate of such organization, the look-through rule applies only to that portion of the income that represents income attributable to the insurance of risks of such other shareholder that is not a tax-exempt affiliate (and does not apply to the portion of the income that represents income attributable to the insurance of risks of the organization itself). In this regard, the Congress intended that if the CFC serves as a vehicle for the separate funding by each shareholder of its risks or liabilities for claims, without any pooling of a shareholder's risks

or liabilities for claims with those of another shareholder either directly or through reinsurance, allocations that fairly reflect such arrangement will be respected for purposes of applying the look-through rule.

Effective Date

The provision is effective for amounts includible in gross income under subpart F in taxable years of a tax-exempt organization beginning after December 31, 1995.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1996, $3 million in 1997, $4 million in 1998, $4 million in 1999, $5 million in 2000, $5 million in 2001, $5 million in 2002, $6 million in 2003, $6 million in 2004, $7 million in 2005, and $8 million in 2006.

4. Depreciation under the income forecast method (sec. 1604 of the Small Business Act and sec. 167 of the Code)

Present and Prior Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and is allowed to recover such cost over time through allowances for depreciation or amortization. Depreciation allowances for tangible property generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which provides that depreciation is computed by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which provides a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

The "income forecast" method is an allowable method for calculating depreciation under section 167 for certain property. The income forecast method had been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings, video games, and other property.[160] Under the income forecast method, the depreciation deduction for a taxable year for a property was determined by multiplying the cost of the property[161] (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The total forecasted or estimated income to be derived from a property was based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate could be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, did not affect the amount of depreciation claimed in a prior taxable year.

In the case of a film, income to be taken into account under the income forecast method meant income from the film less the expense of distributing the film, including estimated income from foreign distribution or other exploitation of the film.[162] In the case of a motion picture released for theatrical exhibition, income did not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition had been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income did not include estimated income from domestic syndication of the series or the film (unless an arrangement for syndication had been entered into before the series or film has been depreciated to its reasonable salvage value).[163] The Internal Revenue Service also had ruled that income does not include net merchandising revenue received from the exploitation of film characters.[164]

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[160] See, e.g., Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 79-285, 1979-2 C.B. 91; and Rev. Rul. 89-62, 1989-1 C.B. 78. Conversely, the courts have held that certain tangible personal property was not of a character to which the income forecast method was applicable. See, e.g., *Carland, Inc. v. Comm.*, 90 T.C. 505 (1988), aff'd. on this issue, 909 F.2d 1101 (8th Cir. 1990) (railroad rolling stock subject to a lease not eligible) and *ABC Rentals of San Antonio v. Comm.*, 68 TCM 1362 (1994) (consumer durable property subject to short-term, "rent-to-own" leases not eligible). ABC Rentals of San Antonio was reversed and remanded to the Tax Court by the Tenth Circuit Court of Appeals after the enactment of the Small Business Act, *ABC Rentals of San Antonio v. Comm.*, No. 95-9008 (10th Cir. 9/27/96).

[161] In *Transamerica Corp. v. U.S.*, 999 F.2d 1362, (9th Cir. 1993), the Ninth Circuit overturned the District Court and held that, for purposes of applying the income forecast method to a film, the "cost of a film" includes "participation" and "residual" payments (i.e., payments to producers, writers, directors, actors, guilds, and others based on a percentage of the profits from the film) even though these payments were contingent on the occurrence of future events. It is unclear to what extent, if any, the *Transamerica* decision applies to amounts incurred after the enactment of the economic performance rules of Code section 461(h), as contained in the Deficit Reduction Act of 1984.

[162] Rev. Rul. 60-358, 1960-2 C.B. 68.

[163] Rev. Proc. 71-29, 1971-2 C.B. 568.

[164] Private letter ruling 7918012, January 24, 1979. Private letter rulings do not have precedential authority and may not be relied upon by any taxpayer other than the taxpayer receiving the ruling but are some indication of IRS administrative practice.

Reasons for Change

The Congress believed that, in theory, the income forecast method is an appropriate method for matching the capitalized cost of certain property with the income produced by such property. However, the Congress believed that the application of the income forecast method under prior law did not meet the theoretical objective. In addition, the Congress recognized that the reliance of the operation of the income forecast method upon estimated income may result in a mismatch between income and depreciation deductions when future income is over- or under-estimated. The Small Business Act addresses these issues.

Explanation of Provision

The Small Business Act provides the following modifications to the income forecast method of prior law.

Determination of estimated income

First, the Small Business Act provides that income to be taken into account under the income forecast method includes all estimated income generated by the property. In applying this rule, a taxpayer generally need not take into account income expected to be generated after the close of the tenth taxable year after the year the property was placed in service. In the case of a film, television show, or similar property, such income includes, but is not necessarily limited to, income from foreign and domestic theatrical, television, and other releases and syndications; and video tape releases, sales, rentals, and syndications.

Pursuant to a special rule, in the case of television and motion picture films, the income from the property shall include income from the financial exploitation of characters, designs, scripts, scores, and other incidental income associated with such films, but only to the extent the income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of sec. 267(b)). As an example of this special rule, assume a taxpayer produces a motion picture the subject of which is the adventures of a newly-created fictional character. If the taxpayer produces dolls or T-shirts using the character's image, income from the sales of these products by the taxpayer to consumers would be taken into account in determining depreciation for the motion picture under the income forecast method. Similarly, if the taxpayer enters into any licensing or similar agreement with an unrelated party with respect to the use of the image, such licensing income would be taken into account in determining depreciation for the motion picture. However, if the taxpayer uses the character's image to promote a ride at an amusement park that is wholly-owned by the taxpayer, no portion of the admission fees for the amusement park are to be taken into account under the income forecast method with respect to the motion picture.

In addition, pursuant to another special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into ac-

count any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period).

The 10th-taxable-year rule, the financial exploitation rule, and the syndication rule apply for purposes of the look-back method described below.

Determination and treatment of costs of property

The adjusted basis of property that may be taken into account under the income forecast method only will include amounts that satisfy the economic performance standard of section 461(h).[165] For this purpose, if the taxpayer incurs a noncontingent liability to acquire property subject to the income forecast method from another person, economic performance will be deemed to occur with respect to such noncontingent liability when the property is provided to the taxpayer. In addition, the recurring item exception of section 461(h)(3) will apply in a manner similar to the way such exception applies under present law. Thus, expenditures that relate to an item of property that are incurred in the taxable year following the taxable year in which the property is placed in service may be taken into account in the year the property is placed in service to the extent such expenditures meet the recurring item exception for such year.

Any costs that are taken into account after the property is placed in service are treated as a separate piece of property to the extent (1) such amounts are significant and are expected to give rise to a significant increase in the income from the property that was not included in the estimated income from the property, or (2) such costs are incurred more than 10 years after the property was placed in service. To the extent costs are incurred more than 10 years after the property was placed in service and give rise to a separate piece of property for which no income is generated, such costs may be written off and deducted in the year in which they are incurred pursuant to the taxpayer's method of accounting. For example, assume a taxpayer places property subject to the income forecast method in service during a taxable year and all income from the property is generated in the following four-year period. If the taxpayer incurs additional costs with respect to that property more than 10 years later (e.g., a payment pursuant to a deferred contingent compensation arrangement to a person that produced the property), such costs may be deducted in the year incurred provided no more income is generated with respect to such costs or the original property.

Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Look-back method

Finally, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or would receive) in-

[165] It is intended that the decision in *Transamerica Corp. v. U.S.* will no longer apply so that amounts that have not yet met the economic performance standard of section 461(h) may not be prematurely capitalized into the adjusted basis of property subject to the income forecast method. No inference is intended as to the proper application of the *Tramsamerica* decision or section 461(h) to the income forecast method under prior law.

terest based on the recalculation of deprecation under a "look-back" method.[166] The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code.[167]

Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years. The Secretary of the Treasury has the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Treasury Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years).

In applying the look-back method, any cost that is taken into account after the property was placed in service may be taken into account by discounting (using the Federal mid-term rate determined under sec. 1274(d) as of the time the costs were taken into account) such cost to its value as of the date the property was placed in service.

Property that had an unadjusted basis of $100,000 or less is not subject to the look-back method. For this purpose, "unadjusted basis" means the total capitalized cost of a property as of the close of a recomputation year.

The Small Business Act provides a simplified look-back method for pass-through entities.

Effective Date

The Small Business Act is effective for property placed in service after September 13, 1995, unless produced or acquired pursuant to a binding written contract in effect on such date and all times thereafter. For this purpose, the binding contract exception may apply to a written contract in effect on the relevant dates if that contract binds a taxpayer to produce, license or deliver property that will be used by the taxpayer or the other party to the contract once the property is produced.

The Small Business Act may apply to property placed in service in taxable years that ended before the date of enactment of the Act. The Small Business Act waives additions to tax imposed under sections 6654, 6655, and 6662(d) for any underpayments of tax or estimated tax for any taxable year ending before the date of enactment of the Act to the extent the underpayment was created or increased

[166] The "look-back" method of the provision resembles the look-back method applicable to long-term contracts accounted for under the percentage-of-completion method of present-law sec. 460.

[167] A technical correction to the statute is necessary to provide the proper cross-reference to section 460(b)(2)(C) for purposes of determining the interest rate applicable to the look-back method of the income forecast method.

by the changes made to the income forecast method of depreciation by the provision. The application of the provision (including the look-back method) is not waived for any taxable year that ends after the date of enactment of the Small Business Act.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $32 million in 1996, $69 million in 1997, $29 million in 1998, $13 million in 1999, $14 million in 2000, $16 million in 2001, $19 million in 2002, $22 million in 2003, $28 million in 2004, $31 million in 2005, and $35 million in 2006.

5. Taxation of punitive damages received on account of personal injury or sickness (sec. 1605 of the Small Business Act and sec. 104(a)(2) of the Code)

Present and Prior Law

Under present and prior law, gross income generally does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)). Under present and prior law, the statute specifically provides that this exclusion does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Under prior law, courts differed as to whether the exclusion applied to punitive damages received in connection with a case involving a physical injury or physical sickness.[168] Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

Under prior law, courts interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income.[169] In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

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[168] However, the Supreme Court has held that punitive damages received by the husband and children of a woman who died of toxic shock syndrome were not received "on account of" personal injuries and, therefore, the exclusion did not apply. *O'gilvie v. U.S.*, Sup. Ct. Nos. 95-966 and 95-977 (Dec. 10, 1996). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner*, 105 T.C. No. 27 (1995).

[169] *Schleier v. Commissioner*, 115 S. Ct. 2159 (1995).

Reasons for Change

Punitive damages are intended to punish the wrongdoer and are not intended to compensate the claimant (e.g., for lost wages or pain and suffering). Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income. Further, including all punitive damages in taxable income provides a bright-line standard which avoids prospective litigation on the tax treatment of punitive damages received in connection with a case involving a physical injury or physical sickness.

Damages received on a claim not involving a physical injury or physical sickness (e.g., employment discrimination or injury to reputation) are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income. The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The Congress believed that the taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.

Explanation of Provision

Include in income all punitive damages

The Small Business Act provides that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the Small Business Act, prior law continues to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action. This exception does not apply with respect to any action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) that only punitive damages may be awarded in a wrongful death action. No inference is intended as to the application of the exclusion to punitive damages received prior to the effective date of the Small Business Act in connection with a case involving a physical injury or physical sickness.

Include in income damage recoveries for nonphysical injuries

The Small Business Act provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive

damages)[170] received on account of a claim of wrongful death continue to be excludable from gross income as under prior law.

The Small Business Act provides that emotional distress is not considered a physical injury or physical sickness.[171] Thus, for example, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. However, because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress (regardless of whether the emotional distress is due to a physical injury or physical sickness).

No inference is intended with respect to the application of the exclusion to damages received prior to the effective date of the Small Business Act in connection with a case not involving a physical injury or physical sickness.

Effective Date

The provision generally is effective with respect to amounts received after the date of enactment (August 20, 1996). The provision does not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1996, $50 million in 1997, $55 million in 1998, $59 million in 1999, $61 million in 2000, $64 million in 2001, $68 million in 2002, $71 million in 2003, $74 million in 2004, $77 million in 2005, and $80 million in 2006.

6. Repeal advance refunds of diesel fuel tax for diesel automobiles, vans, and light trucks (sec. 1606 of the Small Business Act and sec. 6427(g) of the Code)

Present and Prior Law

Excise taxes are imposed on gasoline (14 cents per gallon) and diesel fuel (20 cents per gallon) to fund the Federal Highway Trust Fund. Before 1985, the gasoline and diesel fuel tax rates were the same. The predominate highway use of diesel fuel is by trucks. In 1984, the diesel fuel excise tax rate was increased above the gasoline tax rate as the revenue offset for a reduction in an annual use tax imposed on heavy trucks. Because automobiles, vans, and light trucks did not benefit from the use tax reduction, a provision was

[170] As discussed above, under the Small Business Act, punitive damages received in certain wrongful death actions may be still excludable from gross income to the extent they were excludable under prior law. However, see *O'gilvie v. U.S., supra.*

[171] It is intended that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.

enacted allowing first purchasers of model year 1979 and later diesel-powered automobiles, vans, and light trucks a tax credit to offset this increased diesel fuel tax. The credit was $102 for automobiles, and $198 for vans and light trucks.

Reasons for Change

Changed driving patterns, and vehicles currently being marketed, have resulted in fewer diesel-powered automobiles, vans, and light trucks today than was the case when this advance refund was enacted. Additionally, the 1982 highway cost allocation study on which the refund was based is now outdated. The Congress believed, therefore, that this credit was obsolete and should be repealed.

Explanation of Provision

The tax credit for purchasers of diesel-powered automobiles and light trucks is repealed.

Effective Date

The provision is effective for vehicles purchased after the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year receipts by $1 million in 1996, $15 million in 1997, and $19 million per year during the period 1998 through 2006.

7. Extension and phaseout of excise tax on luxury automobiles (sec. 1607 of the Small Business Act and sec. 4001 of the Code)

Present and Prior Law

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

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

Under prior law, the tax applied to sales before January 1, 2000.

Reasons for Change

The Congress believed that the expiration date of January 1, 2000, at which time the rate of tax on certain automobiles would fall from 10 percent to zero, would create an unacceptable disruption of the automobile market. The Congress believed a more gradual phaseout of the tax would be less disruptive to the market and believed it is appropriate to commence the phaseout in 1996.

Explanation of Provision

The Small Business Act extends and phases out the luxury tax on automobiles. The tax rate is reduced by one percentage point per year beginning in 1996. The tax rate for sales (on or after August 28) in 1996 is 9 percent. The tax rate for sales in 1997 is 8 percent. The tax rate for sales in 1998 is 7 percent. The tax rate for sales in 1999 is 6 percent. The tax rate for sales in 2000 is 5 percent. The tax rate for sales in 2001 is 4 percent. The tax rate for sales in 2002 is 3 percent. The tax will expire after December 31, 2002.

The provision may require technical correction to reflect Congressional intent. Section 1607 of the Small Business Act amends section 4001 of the Code. However, under section 4003 of the Code, a 10-percent tax is imposed on the "separate purchase of vehicle and parts and accessories therefor" when the sum of the separate purchases exceeds the luxury tax threshold. The rate of tax under section 4003 is not determined by reference to section 4001. A technical correction may be required to conform the section 4003 tax to the section 4001 tax.[172]

Effective Date

The provision is effective for sales occurring after the date which is seven days after the date of enactment (on or after August 28, 1996).[173]

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1996, $56 million in 1997, $105 million in 1998, and $132 million in 1999 and is estimated to increase Federal fiscal year budget receipts by $124 million in 2000, $183 million in 2001, $140 million in 2002, and $32 million in 2003.

8. Allow certain persons engaged in the local furnishing of electricity or gas to elect not to be eligible for future tax-exempt bond financing (sec. 1608 of the Small Business Act and sec. 142 of the Code)

Present and Prior Law

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

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[172] Additionally, a technical correction to OBRA93 may be required to conform the tax under section 4003 to the tax under section 4001. Section 4001 indexes the applicable threshold and provides a termination date for the tax. Under present law, section 4003 has an unindexed threshold of $30,000 and no termination date. The legislative history to OBRA93 suggests that this does not reflect Congressional intent when the luxury tax was modified.

[173] The Statement of Managers accompanying the Conference Report on H.R. 3448 (Report 104-737) incorrectly states the effective date to be for sales on or after the seventh day after the date of enactment (p.303).

counties or (2) a city and a contiguous county (commonly referred to as the "local furnishing" of electricity or gas).

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

Reasons for Change

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

Explanation of Provision

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

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

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

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

Except as described below, the Small Business Act further limits the local furnishing exception to bonds for facilities (1) of persons that qualify as engaged in that activity (i.e., have facilities for local furnishing placed in service in that activity) on January 1, 1997, and (2) that serve areas served by those persons on that date. The area which is considered to be served on January 1, 1997, consists of the geographic area in which service actually is being provided on that date. Service initially provided after that date to a new cus-

tomer within that area (e.g., as a result of new construction or of a change in heating fuel type) is not treated as a service area expansion.

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

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

The Small Business Act allows certain expansions of existing local furnishing service areas to occur after January 1, 1997, without affecting continued qualification under the local furnishing exception, both within the existing service area and in the expansion area. Under this provision, a qualified local furnishing service area that includes a portion of a city or a county on January 1, 1997, may be expanded after that date to include other portions of the same city or county. For example, if a gas utility's service area on January 1, 1997, includes only an urban section of a county, a subsequent expansion of the utility's service area to include rural portions of the same county (e.g., as a result of population growth) does not, in itself, preclude qualification of the entire, expanded service area as a local furnishing area. This exception, however, does not allow expansion of local furnishing service areas beyond the borders of a city or county where service is being provided on January 1, 1997, or interconnection of facilities serving those areas with other facilities or persons occurs in a manner not permitted present and under prior law.

The Small Business Act also clarifies certain questions with respect to the limitation on future eligibility under the local furnishing exception. First, because the Small Business Act precludes issuance of tax-exempt bonds except for local furnishers engaged in that activity on January 1, 1997 (and successors in interest), the statutory wording of the Small Business Act differs from the traditional focus of the local furnishing exception on a two county (or city and contiguous county) area without regard to the entity pro-

viding the service. The statutory references to "persons" engaged in the local furnishing of electricity or gas contained in the conference agreement were intended to prevent new entities (other than successors in interest) from qualifying for tax-exempt financing under the local furnishing exception. They are not to be construed in a manner affecting the tax-exempt status of interest on any outstanding bonds or the receipt of additional tax-exempt financing by an existing local furnisher, provided that the facilities financed with those bonds are used at all times in qualified local furnishing activities (as defined under prior law as modified by the Act) and the bonds comply otherwise with the Internal Revenue Code's requirements for tax-exemption.

Second, the Small Business Act confirms no change was intended in the prior-law rule that disregards certain transmission of electricity pursuant to FERC orders in determining whether a facility is used in the local furnishing of electricity.

The application of the restriction on qualified local furnishing activities to certain utility transactions such as those that may be expected to occur as a result of deregulation of the electric and gas industries may be clarified by the following examples:

Example (1).—As part of a corporate reorganization, an existing local furnishing utility sells a portion of its service area to a third party. The retained portion of the utility's service territory continues to qualify for tax-exempt financing under the local furnishing exception provided that no violations of that exception, such as an impermissible interconnection with facilities outside the area, occur. The determination of whether the portion of the service territory that is sold to a third party continues to qualify under the local furnishing exception depends on the manner in which the purchaser provides service in the area it acquires. If, for example, the purchaser operates in the area which it purchases in a manner that otherwise qualifies under the local furnishing exception, the purchaser is treated as a successor in interest to the seller and facilities for the area that is sold continue to be treated as used in local furnishing. However, if that area is merged into, or impermissibly interconnected with, another service area that does not qualify as a local furnishing area after the transaction, the successor in interest rule does not preserve the status of the area sold as a local furnishing area.

Example (2).—Two independent utilities, both qualifying as engaged in local furnishing on January 1, 1997, serve adjoining areas. The utilities decide to adjust their common service area boundary line to eliminate irregular geographic patterns. The parties to this transaction may be treated as successors in interest with respect to the area each acquires if the resulting service areas each qualify under the local furnishing exception (as modified by the Small Business Act).

Example (3).—Assume the facts of Example (2), except the area acquired by one of the utilities is in a county where it did not provide service before the boundary line adjustments, and the utility's resulting service area includes all or part of three counties. That utility would no longer qualify as engaged in local furnishing under prior law. The result is the same under the Act.

Example (4).—Assume the facts of Example (2), except the utilities merge into a single company with a single service area. If the resulting combined service area of the new company does not exceed two counties (or a city and a contiguous county), the new company continues to be eligible for tax-exempt financing as a successor in interest.

Example (5).—Assume that a local furnishing utility decides to contract with a newly-formed independent power generating venture to construct a generating plant that will sell electricity to it exclusively for use in its service area. Tax-exempt bonds may not be issued under the local furnishing exception for construction of the generating plant. The independent power producer was neither engaged in the local furnishing of electricity to the service area involved on January 1, 1997, nor is it a successor in interest.

Effective Date

These provisions were effective on the date of enactment (August 20, 1996).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1998, to decrease those receipts by $3 million in 1999, $6 million in 2000, $4 in 2001, $3 million in 2002, and less than $500,000 in 2003. Fiscal year receipts further are estimated to be increased by $7 million in 2004, $13 million in 2005, and $15 million in 2006.

9. Extension of Airport and Airway Trust Fund excise taxes (sec. 1609 of the Small Business Act and secs. 4041, 4081, 4261, and 4271 of the Code)

Present and Prior Law

Extension of aviation taxes

Before January 1, 1996, the following excise taxes were imposed to fund the Airport and Airway Trust Fund: (1) a 10-percent tax on domestic air passenger transportation; (2) a 6.25-percent tax on domestic air freight transportation; (3) a $6-per-person tax on international air departures; (4) a 17.5-cents-per-gallon tax on jet fuel used in noncommercial aviation; and (5) a 15-cents-per-gallon tax on gasoline used in noncommercial aviation (14 cents per gallon of this tax continued after December 31, 1995, with the revenues being deposited in the Highway Trust Fund). In addition, jet fuel and gasoline used in commercial and noncommercial aviation are subject to a tax of 4.3 cents per gallon, the revenues of which are deposited in the General Fund of the Treasury. Prior to January 1, 1996, of the total tax of 19.3 cents per gallon imposed on gasoline used in noncommercial aviation, 18.3 cents per gallon was imposed when the gasoline was removed from a pipeline or barge terminal. The remaining one cent per gallon was imposed at the retail level.

Exemption for certain medical air transportation

An exemption was provided from the air passenger, freight, and fuels taxes for emergency medical helicopter transportation if the helicopter did not take off from or land at Federally assisted airports or otherwise use Federal aviation facilities or services.

Exemption for helicopters used in exploration or development of hard minerals or oil or gas

An exemption was provided from the air transportation taxes for helicopter transportation for exploration, development, or removal of hard minerals or oil or gas if the helicopter did not take off from or land at Federally assisted airports or otherwise use Federal aviation facilities or services.

Transportation of employees of affiliated companies

Generally, when employees fly on their employer's aircraft, the fuel tax applies, but when a company flies other passengers for compensation or hire, the air passenger ticket tax applies. Employees of affiliated corporations do not cause the air passenger tax to apply. The Internal Revenue Service interpreted the use limitation of prior-law Code section 4282 on an all-or-nothing basis relating to aircraft of affiliated groups. That is, if an aircraft was available for hire by persons outside the affiliated group, all amounts paid for transportation, including charges among members of an affiliated group, were subject to the air passenger *ticket* tax rather than the fuels taxes.[174]

Reasons for Change

The aviation excise taxes, which expired after December 31, 1995, fund important Federal air transportation services. Their expiration is depleting monies available to finance these services, which the Congress has reauthorized for a two-year period beginning on October 1, 1996. The Congress determined that a short-term extension of those taxes will provide needed revenue for the Airport and Airway Trust Fund.

Explanation of Provisions

Reimposition of aviation taxes

The five Airport and Airway Trust Fund excises taxes are reinstated at the pre-1996 rates for the period beginning seven days after the date of enactment (August 27) through December 31, 1996.

The Small Business Act also consolidates imposition of the aviation gasoline excise tax, with the entire 19.3-cents-per-gallon rate on noncommercial aviation being imposed when the gasoline is removed from a pipeline or barge terminal facility.

Exemption for certain medical air transportation

The Small Business Act: (1) expands the exemption for emergency medical helicopters to also include fixed-wing aircraft equipped for and exclusively dedicated to acute care emergency

[174] Rev. Rul. 77-405, 1977-2 C.B. 381; Rev. Rul. 76-394, 1976-2 C.B. 355.

medical services; and (2) removes the reference to non-use of Federally assisted airports or other Federal aviation facilities or services for such medical aircraft to qualify for the exemption. The Congress intended that this exemption be applied on a flight-by-flight basis.

Exemption for helicopters used in exploration or development of hard minerals or oil or gas

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

Transportation of employees of affiliated groups

The Small Business Act provides that the determination of which tax, the air passenger ticket tax or the fuels taxes, applies to flights of aircraft of affiliated groups of corporations will be made on a flight-by-flight basis.

Effective Date

The reinstatement of the aviation excise taxes and the modifications to certain exemptions and interputations of those taxes is effective beginning seven days after the date of the provision's enactment (on or after August 27, 1996); however, the air passenger ticket and freight waybill taxes do not apply to any amount paid before that date for transportation occurring during the period when the taxes otherwise are reinstated.

Floor stocks taxes are imposed on aviation fuels held on the effective date of the provision beyond the point of distribution at which tax generally is imposed. This tax does not apply to fuel destined for a tax-free use (including fuel destined for use in commercial aviation, on which the 4.3-cents-per-gallon General Fund tax already has been paid).[175]

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $28 million in 1996, $1,528 million in 1997, and to decrease receipts by less than $500,000 annually during the period 1998 through 2006.

10. Modify basis adjustment rules under section 1033 (sec. 1610 of the Small Business Act and sec. 1033 of the Code)

Present and Prior Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the

[175] A technical correction may be necessary to effect this exemption for partially taxable fuel.

converted property within a specified replacement period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. In cases in which a taxpayer purchased stock as replacement property, the taxpayer generally reduced the basis of the stock, but did not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally did not result in reduced depreciation deductions where the acquired corporation held depreciable property, and may have resulted in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

Reasons for Change

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

Explanation of Provision

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

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

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

Example 2.—Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of

$100,000 (rather than $1 million) in the building. Under the Small Business Act, the taxpayer reduces its basis in the stock to $100,000 (as under prior law) and the corporation is not required to reduce its adjusted basis in the building.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1997, $5 million in 1998, $9 million in 1999, $14 million in 2000, $20 million in 2001, $29 million in 2002, $37 million in 2003, $46 million in 2004, $56 million in 2005, and $64 million in 2006.

11. Treatment of certain insurance contracts on retired lives (sec. 1611 of the Small Business Act and sec. 817(d) of the Code)

Present and Prior Law

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

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

Under prior law, a variable contract generally was defined as any annuity or life insurance contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and (2) under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, property, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.

Reasons for Change

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

Explanation of Provision

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

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

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in 1997 and $1 million in 1998, reduce such receipts by $2 million in 1999, increase such receipts by $5 million in 2000 and $2 million in 2001, reduce such receipts by less than $500,000 in 2002, increase such receipts by $10 million in 2003, reduce such receipts by $5 million in 2004, increase such receipts by $2 million in 2005 and reduce such receipts by $3 million in 2006.

12. Treatment of modified guaranteed contracts (sec. 1612 of the Small Business Act and sec. 817A of the Code)

Present and Prior Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The life insurance reserve of a life insurance company is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that under prior law, any market value adjustment required on surrender was not taken into account. In no event, however, may the amount of the reserve for

tax purposes at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.

Reasons for Change

Life insurance companies have recently begun issuing annuity contracts, life insurance contracts, and pension plan contracts that provide for a guaranteed interest rate for a specified period of time and a market value adjustment in the event that the owner of the contract surrenders the contract for cash prior to the end of the guaranteed interest period. These contracts are commonly referred to as "modified guaranteed contracts."

If the premium or other consideration received under a modified guaranteed contract is allocated to an account that is segregated from the general asset accounts of the life insurance company, then the reserve for the contract and the assets in the segregated account generally are required to be taken into account at market value for annual statement purposes. For Federal income tax purposes, the reserve for a modified guaranteed contract may reflect the market value adjustment, while the market fluctuations in the assets underlying the contract are not taken into account unless the assets are disposed of.

The Congress considered it appropriate to conform the Federal income tax treatment of modified guaranteed contracts with the annual statement treatment of such contracts in order to simplify the accounting for such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts.

Explanation of Provision

The Small Business Act generally applies a mark-to-market regime to assets held as part of a segregated account under a modified guaranteed contract issued by a life insurance company. Gain or loss with respect to such assets held as of the close of any taxable year are taken into account for that year (even though the assets have not been sold or exchanged),[176] and are treated as ordinary. If gain or loss is taken into account by reason of the mark-to-market requirement, then the amount of gain or loss subsequently realized as a result of sale, exchange, or other disposition of the asset, or as a result of the application of the mark-to-market requirement is appropriately adjusted to reflect such gain or loss. In addition, the reserve for a modified guaranteed contract is determined by taking into account the market value adjustment required on surrender of the contract.

A modified guaranteed contract is defined as any life insurance contract, annuity contract or pension plan contract[177] that is not

[176] The wash sale rules of section 1091 of the Code are not to apply to any loss that is required to be taken into account solely by reason of the mark-to-market requirement.

[177] The provision applies only to a pension plan contract that is not a life, accident or health, property, casualty, or liability contract.

a variable contract (within the meaning of Code section 817), and that satisfies the following requirements. All or a part of the amounts received under the contract must be allocated to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company and is valued from time to time by reference to market values.

The reserves for the contract must be valued at market for annual statement purposes and the Federally prescribed reserve for the contract under section 807(d)(2) must be valued at market. Further, a modified guaranteed contract includes only a contract that provides either for a net surrender value or for a policyholder's fund (within the meaning of section 807(e)(1)). It is intended that a policyholder's fund be more than de minimis. For example, Treasury regulations could provide that a policyholder's fund that represents 15 percent or less of the insurer's reserve for the contract under section 807, and that is attributable to employee contributions, would be considered de minimis.

If only a portion of the contract is not described in section 817, that portion is treated as a separate contract for purposes of the provision.

The Treasury Department is authorized to issue regulations that provide for the application of the mark-to-market requirement at times other than the close of a taxable year or the last business day of a taxable year. The Treasury Department is also authorized to issue such regulations as may be necessary or appropriate to carry out the purposes of the provision and to provide for the treatment of modified guaranteed contracts under sections 72, 7702, and 7702A. In addition, the Treasury Department is authorized to determine the interest rates applicable under sections 807(c)(3), 807(d)(2)(B) and 812 with respect to modified guaranteed contracts annually, calculating such rates as appropriate for modified guaranteed contracts. The Treasury Department has discretion to determine an appropriate rate that is a current market rate, which could be determined, for example, either by using a rate that is appropriate for the obligations under the contract to which the reserve relates, or by taking into account the yield on the assets underlying the contract. The Treasury Department may exercise this authority by issuing a periodic announcement of the appropriate market interest rates or formula for determining such rates. The Treasury Department is also authorized, to the extent appropriate for such a contract, to modify or waive section 811(d).

The Treasury Department is also authorized to provide rules limiting the ordinary treatment provided under the provision to gain or loss on those assets properly taken into account in calculating the reserve for Federal tax purposes (and necessary to support such reserves) for modified guaranteed contracts, and to provide rules for limiting such treatment with respect to other assets (such as assets representing surplus of the company). Particular concern has been expressed about characterization of gain or loss as ordinary under the provision in transactions that would otherwise either (1) have to meet the requirements of the hedging rules under the section 1221 Treasury regulations to receive this treatment, or (2) be treated as capital transactions under present law. It is intended that the mark-to-market treatment apply to all assets held as part

of a segregated account established under the provision, even though ordinary treatment may not apply (pursuant to Treasury regulatory authority) to assets held as part of the segregated account that are not necessary to support the reserve for modified guaranteed contracts.

The Small Business Act authorizes the Treasury Department to prescribe regulations that provide for the treatment of assets transferred to or from a segregated account. This regulatory authority is provided because of concern that taxpayers may exercise selective ordinary loss (or income or gain) recognition by virtue of the ordinary treatment under the provision. One example of selective ordinary loss recognition could arise if assets are always marked to market when transferred out of the segregated account. For example, if at the beginning of the taxable year an asset in the segregated account is worth $1,000, but declines to $900 in July, the taxpayer might choose to recognize $100 of ordinary loss while continuing to own the asset, simply by transferring it out of the segregated account in July and replacing $1,000 of cash (for example) in the segregated account.

It is intended that the regulations relating to asset transfers will forestall opportunities for selective recognition of ordinary items. Prior to the issuance of these regulations, the following rules shall apply.

If an asset is transferred to a segregated account, gain or loss attributable to the period during which the asset was not in the segregated account is taken into account when the asset is actually sold, and retains the character (as ordinary or capital) properly attributable to that period. Appropriate adjustments are made to the basis of the asset to reflect gain or loss attributable to that period.

If an asset is transferred out of a segregated account, the transfer is deemed to occur on the last business day of the taxable year and gain or loss with respect to the transferred asset is taken into account as of that day. Loss with respect to such transferred asset is treated as ordinary to the extent of the lesser of (1) the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the last business day of the taxable year (or the date the asset was actually sold by the taxpayer, if earlier) or (2) the loss (if any) that would have been recognized if the asset had been sold for its fair market value on the date of the transfer out of the segregated account. A similar rule applies for gains. Proper adjustment is made in the amount of any gain or loss subsequently realized to reflect gain or loss under the provision.

For example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated account in July at a value of $900, is retained by the company and is worth $950 on the last business day of the taxable year. A $50 ordinary loss is taken into account with respect to the asset for the taxable year (the difference between $1,000 and $950). The asset is not marked to market in any subsequent year under the provision, provided that it is not transferred back to the segregated account.

As an additional example, assume that a capital asset in the segregated account that is worth $1,000 at the beginning of the year is transferred out of the segregated accounted in July at a value

of $900, is retained by the company and continues to decline in value to $850 on the last business day of the taxable year. A $100 ordinary loss ($1,000 less $900) and a $50 capital loss ($900 less $850) is taken into account with respect to the asset for the taxable year.

Effective Date

The provision applies to taxable years beginning after December 31, 1995. A taxpayer that is required to (1) change its calculation of reserves to take into account market value adjustments and (2) mark to market its segregated assets in order to comply with the requirements of the provision is treated as having initiated changes in method of accounting and as having received the consent of the Treasury Department to make such changes.

Except as otherwise provided in special rules (described below), the section 481(a) adjustments required by reason of the changes in method of accounting are to be taken into account as ordinary income for the taxpayer's first taxable year beginning after December 31, 1995.

Special rules providing for a seven-year spread apply in the case of certain losses (if any), and in the case of certain reserve increases (if any), in order to limit selective loss recognition or selective minimization of gain recognition. Thus, the seven-year spread rule applies when the taxpayer's section 481(a) adjustment is negative.

First, if, for the taxpayer's first taxable year beginning after December 31, 1995, (1) the aggregate amount of the loss recognized by reason of the change in method of accounting with respect to segregated assets under modified guaranteed contracts (i.e, the switch to a mark-to-market regime for such assets) exceeds (2) the amount included in income by reason of the change in method of accounting with respect to reserves (i.e, the change permitting a market value adjustment to be taken into account with respect to a modified guaranteed contract), then the excess is not allowed as a deduction in the taxpayer's first taxable year beginning after December 31, 1995. Rather, such excess is allowed ratably over the period of seven taxable years beginning with the taxpayer's first taxable year beginning after December 31, 1995. The adjusted basis of each such segregated asset is nevertheless determined as if such losses were realized in the taxpayer's first taxable year beginning after December 31, 1995.

Second, if, for the taxpayer's first taxable year beginning after December 31, 1995, (1) the aggregate amount of the taxpayer's deduction that arises by reason of the change in method of accounting with respect to reserves (i.e., the change permitting a market value adjustment to be taken into account with respect to a modified guaranteed contract), exceeds (2) the aggregate amount of the gain recognized by reason of the change in method of accounting with respect to segregated assets under modified guaranteed contracts (i.e., the switch to a mark-to-market regime for such assets), then the excess is not allowed as a deduction in the taxpayer's first taxable year beginning after December 31, 1995. Rather, such excess is allowed ratably over the period of seven taxable years beginning

with the taxpayer's first taxable year beginning after December 31, 1995.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million in 1997, and increase such receipts by $3 million in 1998, $2 million in 1999, and $2 million in 2000, and to reduce such receipts by $1 million in 2001, $1 million in 2002, and by less than $500,000 in each of 2003 through 2006.

13. Treatment of contributions in aid of construction for water utilities (sec. 1613(a) of the Small Business Act and sec. 118 of the Code)

Present and Prior Law

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

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

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

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

Reasons for Change

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

Explanation of Provision

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

Under the Small Business Act, any amount of money or other property received from any person (whether or not a shareholder) by a regulated public utility that provides water or sewerage disposal services will be treated as a tax-free contribution to the capital of the utility if (1) such amount is a contribution in aid of construction; (2) in the case of contributions of property other than water or sewerage disposal facilities, an expenditure rule is met; and (3) the amount of the contribution is not included in the utility's rate base for ratemaking purposes.

For this purpose, the term "contribution in aid of construction" will be defined by Treasury regulations, except that such term will not include amounts paid as service charges for starting or stopping services. The term "regulated public utility" has the meaning given such term by section 7701(a)(33), except that the term will not include any utility that is not required to provide water or sewerage disposal services to members of the general public in its service area.

The expenditure rule applicable to contributions of property (including cash) other than water or sewerage disposal service facilities is met if (1) an amount equal to the amount of the contribution is expended by the utility for the acquisition or construction of tangible property for which the contribution was made (or is the same type of such property)[178] and the property is used by the utility predominantly[179] in the trade or business of furnishing water or sewerage disposal services; (2) the expenditure occurs before the end of the second taxable year after the year that the contribution was received; and (3) accurate records were kept by the utility with respect to the amount, timing, and identification of the contribution and the related expenditure.

No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution in aid of construction. The adjusted basis of any property acquired with a contribution in aid of construction will be zero.

The statute of limitations for the assessment of deficiencies is extended in the case of amounts that the taxpayer treats as contributions to its capital.

Effective Date

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

[178] It is expected that this property requirement will be narrowly construed so that, in order to meet the expenditure rule, the acquired or constructed property must be the property that motivated the contribution or is substantially identical to property that motivated the contribution.

[179] For this purpose, "predominantly" means 80 percent or more.

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Revenue Effect

The revenue effect of this provision is included with the revenue effect of item 14 regarding the depreciation of water utility property over 25 years.

14. Require water utility property to be depreciated over 25 years (sec. 1613(b) of the Small Business Act and sec. 168 of the Code)

Present and Prior Law

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

Reasons for Change

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

Explanation of Provision

The Small Business Act provides that water utility property will be depreciated using a 25-year recovery period and the straight-line method for regular tax purposes. For this purpose, "water utility property" means (1) property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to the provision, would have a recovery period of 20 years and (2) any municipal sewer. Such property generally is described in Asset Classes 49.3 and 51 of Revenue Procedure 87-56, 1987-2 C.B. 674. The Small Business Act does not change the class lives of water utility property for purposes of the alternative depreciation system of section 168(g).

Effective Date

The provision is effective for property placed in service after June 12, 1996, other than property placed in service pursuant to a binding contract in effect before June 10, 1996, and at all times thereafter before the property is placed in service.

Revenue Effect

The provision, combined with the provision to provide an exclusion for contributions in aid of construction received by water utilities, is estimated to reduce Federal fiscal year budget receipts by $21 million in 1997, $9 million in 1998, and $3 million in 1999, and increase Federal fiscal year budget receipts by $11 million in 2000,

$24 million in 2001, $35 million in 2002, $45 million in 2003, $55 million in 2004, $64 million in 2005, and $73 million in 2006.

15. Allow conversion of scholarship funding corporation to taxable corporation (sec. 1614 of the Small Business Act and sec. 150 of the Code)

Present and Prior Law

Qualified scholarship funding corporations

Under both prior and present law, qualified scholarship funding corporations are nonprofit corporations established and operated exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965 (sec. 150(d)). Such corporations must be organized at the request of a State or political subdivision thereof. In addition, a qualified scholarship funding corporation must be required by its corporate charter and bylaws, or under State law, 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 United States.

Qualified student loan bonds

In general, State and local government bonds issued to finance private loans (e.g., student loans) are taxable private activity bonds. However, interest on qualified student loan bonds is tax-exempt.

Qualified student loan bonds are obligations that are part of an issue all, or a major portion, of the proceeds of which are used, directly or indirectly, to finance loans to students who meet certain requirements. Such loans must be made under a program of general application to which the Higher Education Act of 1965 applies and with respect to which special allowance payments (SAP) under the Higher Education Act of 1965 are authorized. In addition, the program must restrict the maximum amount of loans that may be outstanding to any student and the maximum rate of interest payable on any loan, and the loans must be guaranteed by the Federal government. Finally, the financing of loans under the program must not be limited by Federal law to the proceeds of tax-exempt bonds.

Qualified scholarship funding corporations are eligible issuers of qualified student loan bonds.

Arbitrage restrictions and rebate requirement

The Internal Revenue Code restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that profits on investments that are unrelated to the government purpose for which the bonds are issued be rebated to the United States.

These arbitrage restrictions limit, for example, the amount by which interest charged on loans to students may exceed interest paid on qualified student loan bonds. This amount 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 (1) two percentage points plus reasonable administrative costs or (2) all

reasonable direct costs of the loan program (including issuance costs and bad debt losses). Special allowance payments (SAP) made by the Department of Education are treated as interest on notes and, therefore, are included within the 2-percent limit.

Private foundation excess business holding restrictions

The activities and assets of private foundations are subject to certain restrictions, including the "excess business holding" limitations of section 4943. These rules limit the combined ownership of a business enterprise by a private foundation and all disqualified persons by imposing a tax on the "excess business holdings" of any private foundation. Generally, a private foundation and disqualified persons may, in the aggregate, own 20 percent of the voting stock of a functionally unrelated corporation. If third parties control the unrelated corporation, such aggregate percentage interest may be increased to 35 percent.

The excess business holding rules do not apply if a private foundation owns an interest in a "functionally-related business." A "functionally-related business" is one that is (1) not an unrelated trade or business within the meaning of section 513 or (2) carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that are related to the foundation's exempt purposes.

Reasons for Change

The Congress provided in 1993 for certain loans to students be made directly by the Federal Government. To the extent that such direct loan programs provide loans to students, loan programs such as those provided by qualified scholarship funding corporations will be reduced and possibly terminated. The Congress believed that those corporations should be given an opportunity to engage in new education-related activities without jeopardizing the tax-exempt character of their debt. In addition, the Congress believed that profits accumulated by those corporations may be used as seed capital for those new activities, but that those funds be dedicated for charitable purposes. Accordingly, the Congress believed that the assets and liabilities of such corporations may be transferred to a taxable subsidiary in exchange for its stock so long at the corporation becomes a charitable corporation and the terms of the subsidiary's stock are protect the charity's interests.

Explanation of Provision

In general

The Small Business Act provides that a nonprofit student loan funding corporation may elect to cease its status as a qualified scholarship funding corporation. If the corporation meets the requirements outlined below, such an election would not cause any bond outstanding as of the date of the issuer's election and any bond issued to refund such a bond to fail to be a qualified student loan bond. Accordingly, the interest on such bonds would remain tax-exempt to the bondholders. Once made, an election may be revoked only with the consent of the Secretary of Treasury.

Requirements

First, upon making the election, the issuer would be required to transfer all of the student loan notes to another, taxable, corporation in exchange for senior stock of such corporation within a reasonable period of time after the election is made. Immediately after the transfer, the issuer, and any other issuer who made the election, would be required to hold all of the senior stock of the corporation. Senior stock would be stock whose rights to dividends, liquidation or redemption rights are not inferior to those of any other class of stock and that (1) participates pro rata and fully in the equity value of any other common stock of the corporation, (2) has the right to payments receivable in liquidation prior to any other stock in the corporation, (3) upon liquidation or redemption, has a fixed right to receive the greater of (a) the fair market value of the stock at the date of liquidation or redemption or (b) the net fair market value of all assets transferred to the corporation by the issuer, and (4) has a right to require its redemption by a date which is not 10 years after the date that the election is made.

In addition, the transferee corporation would be required to assume or otherwise provide for the payment of all the qualified scholarship funding bond indebtedness of the issuer within a reasonable period after the election. To the extent permitted by law, the transferee corporation would be required to assume all of the responsibilities and succeed to all of the rights of the issuer under the issuer's agreements with the Secretary of Education with respect to student loans.

Further, immediately after the transfer, the issuer (i.e., the nonprofit student loan funding corporation) would be required to become a charitable organization (described in section 501(c)(3) that is exempt from tax under section 501(a)), at least 80 percent of the members of its board of directors must be independent members, and which must hold all of the senior stock of the corporation.

Consequences of election

After making the election, the issuer would not be authorized to issue any new tax-exempt bonds. On the other hand, any bonds issued to refund such bonds must be issued by a governmental entity because a qualified scholarship funding corporation would no longer exist.

Application of restriction on excess business holdings

For purposes of the excess business holding restrictions imposed on a private foundation, the corporation to which the issuer makes the transfer would be treated as a "functionally-related business" with respect to the issuer if more than 50 percent of the gross income of such corporation is derived from, or more than 50 percent of the assets (by value) of such corporation consists of, student loan notes incurred under the Higher Education Act of 1965.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1997, $6 million in 1998, $8 million in 1999, $10 million in 2000, $10 million in 2001, $9 million in 2002, $7 million in 2003, $6 million in 2004, $5 million in 2005, and $4 million in 2006.

16. Apply mathematical or clerical error procedures for dependency exemptions and filing status when correct taxpayer identification numbers are not provided (sec. 1615 of the Small Business Act and secs. 21, 151 and 6213 of the Code)

Present and Prior Law

In general

Individuals who claim personal exemptions for dependents must include on their tax return the name and taxpayer identification number (TIN) of each dependent. For returns filed with respect to tax year 1996, individuals must provide a TIN for all dependents born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, individuals must provide TINs for all dependents, regardless of their age. An individual's TIN is generally that individual's social security number.

If the individual fails to provide a correct TIN for a dependent, the Internal Revenue Service may impose a $50 penalty.

Mathematical or clerical errors

The IRS may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Explanation of Provision

If an individual fails to provide a correct TIN for a dependent, the IRS is authorized to deny the dependency exemption. Such a change also has indirect consequences for other tax benefits currently conditioned on being able to claim a dependency exemption (e.g., head of household filing status and the dependent care credit). In addition, the failure to provide a correct TIN for a dependent

will be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that failure will not be treated as a notice of deficiency.

Effective Date

The provision is effective for tax returns for which the due date (without regard to extensions) is 30 days or more after the date of enactment. For taxable years beginning in 1996, no requirement to obtain a TIN applies in the case of dependents born after November 30, 1996.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $133 million in 1997, $272 million in 1998, $262 million in 1999, $249 million in 2000, $242 million in 2001, $234 million in 2002, $226 million in 2003, $217 million in 2004, $209 million in 2005, and $201 million in 2006.

17. Treatment of bad debt deductions of thrift institutions (sec. 1616 of the Small Business Act and sec. 593 of the Code)

Prior Law and Background

Reserve method of accounting for bad debts of thrift institutions

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method of sec. 166). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) were allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions computed deductions for bad debts using either the specific charge-off method or the reserve method of section 593. To qualify for this reserve method, a thrift institution must have met an asset test, requiring that 60 percent of its assets consisted of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage was computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution used the reserve method of accounting, it established and maintained a reserve for bad debts, charged actual losses against the reserve, and was allowed a deduction for annual additions to restore the reserve to its permitted balance. Under section 593, a thrift institution annually elected to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method also available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally was allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined

without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally was allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). For taxable years beginning after 1987, the base year was the last taxable year beginning before 1988. Prior to 1988, computing bad debts under a "base year" rule allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the institution's actual losses that were charged off during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with adjusted bases of assets of $500 million or less) may use the experience method of section 585 or the specific charge-off method of section 166 for purposes of computing its deduction for bad debts. A large commercial bank only may use the specific charge-off method. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve balance in excess of the balance of related loans is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution became a commercial bank, or if the institution failed to satisfy the 60-percent qualified asset test, it was required to change its method of accounting for bad debts and, under proposed Treasury regulations,[180] was required to recapture its bad debt reserve. The percentage-of-taxable-income portion of the reserve generally was included in income ratably over a 6-taxable year period. The experience method portion of the reserve was not restored to income if the former thrift institution qualified as a small bank. If the former thrift institution was treated as a large bank, the experience method portion of the reserve was restored to income ratably over a 6-taxable year period, or under the 4-year recapture method or the cut-off method described above.

In addition, a thrift institution was subject to a form of reserve recapture even if the institution continued to qualify for the percentage of taxable income method. Specifically, if a thrift institu-

[180] Prop. Treas. reg. sec. 1.593-13.

tion distributed to its shareholders an amount in excess of its post-1951 earnings and profits, such excess was deemed to be distributed from the nonexperience portion of the institution's bad debt reserve and was restored to income. In the case of any distribution in redemption of stock or in partial or complete liquidation of an institution, the distribution was treated as first coming from the nonexperience potion of the bad debt reserves of the institution (sec. 593(e)).

Financial accounting treatment of tax reserves of bad debts of thrift institutions

The recapture of the entire bad debt reserve for Federal income tax purposes may have created significant financial and regulatory accounting implications for a thrift institution.[181] In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deducted for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will become liable for tax in a future period when the timing item "reverses" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required with respect to pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was thought to be indefinite (i.e., generally, a reversal only would occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and it appears that thrift institutions generally have recorded additional deferred tax liabilities for these additions under the applicable generally accepted accounting principles.[182]

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[181] Certain banking legislation considered in the 104th Congress would have required Federally-chartered thrift institutions to become Federally-chartered banks or State-chartered thrift institutions. Absent tax legislation, the conversion from a thrift charter to a bank charter generally would have required the entire bad debt reserve of the former thrift institution to be recaptured.

[182] As described above, under the experience method, a thrift institution generally was allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). For taxable years beginning after 1987, the base year was the last taxable year beginning before 1988. How the establishment of 1987 as a permanent base year changed the nature of the bad debt reserves of thrift institutions between pre-1988 years and post-1987 years (which, in turn, contributed to the change in the financial accounting treatment of such reserves) can be illustrated by the following example:

Pre-1988 treatment.—Assume that a thrift institution ("T") always had used the percentage of taxable income ("PTI") method to deduct bad debts through 1986 when its reserve balance was $10,000. Further assume that in 1987, T: (1) has insufficient taxable income to use the PTI method, (2) has actual bad debt losses of $1,000, and (3) under the experience method, would be allowed a deduction of $900. Under these facts, T would be allowed a bad debt deduction of $1,000 (rather than $900) in 1987 because $1,000 is the amount necessary to restore the reserve to its base year (PTI) level. Specifically, in 1987, T would reduce the year-end 1986 reserve of $10,000 for the $1,000 actual loss and then add (and deduct) $1,000 to the reserve so that the balance of the reserve at year end 1987 is once again $10,000. Thus, T's pre-1987 PTI deduc-

Continued

Under proposed Treasury regulations, if a thrift institution became a commercial bank (or is otherwise ineligible to use the bad debt reserve method of sec. 593), the institution was required to recapture all or a portion of its bad debt reserve. Pursuant to the generally accepted accounting principles described in the paragraph above, it appears that such recapture required the institution immediately to record, for financial accounting purposes, a current or deferred tax liability for the amount of bad debt recapture for which liabilities previously had not been recorded (generally, with respect to the pre-1988 reserves), regardless of when such recapture was taken into account for Federal income tax purposes. To the extent regulatory accounting principles followed these financial accounting principles, the recording of this liability generally decreased the regulatory capital of the institution.

Reasons for Change

The Congress believed that the reserve method of bad debts accorded to qualified thrift institutions under present law results in a mismeasurement of economic income and provides those institutions with a tax benefit not provided to similarly-situated depository institutions.

The Congress also believed that whenever a taxpayer changes its method of accounting, it is appropriate to implement the change in a manner so that items of income or expense are not taken into account twice—once under the old method and again under the new method. Thus, under present law, most accounting method changes are implemented under section 481 which requires the calculation of an adjustment that reflects the cumulative effect of the method change and is restored to income over a specified period of time. Specifically, under prior law, whenever a thrift institution no longer qualified for the reserve method of accounting for bad debts, the bad debt reserve of the thrift institution was restored to income.

The Congress believed that, in order to provide similar treatment to similarly-situated depository institutions, the special bad debt reserve methods available to qualified thrift institutions should be repealed. However, the Congress understood that requiring full recapture of the bad debt reserves of thrift institutions in implementing this change in accounting method may have imposed significant financial accounting and regulatory capital burdens on institutions that had not recorded the appropriate amount of deferred tax liabilities with respect to such recapture. Thus, the Congress believed it was appropriate to provide relief from the recapture of the

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tions, which gave rise to the $10,000 reserve balance, generally never would be restored to income (unless subject to sec. 593(e)) because the reserve could always be restored to no less than the $10,000 balance.

Post-1987 treatment.— Further assume that in 1988, T has sufficient taxable income to be allowed a PTI deduction of $1,500, increasing the balance of the reserve to $11,500 at year-end 1988. Further assume that in 1989, T: (1) again has insufficient taxable income to use the PTI method, (2) has actual bad debts of $2,500, and (3) under the six-year average formula of the experience method would be allowed a deduction of $900. Under these facts, T would be allowed a deduction of $1,000 (i.e., the amount necessary to in the restore the reserve to its base year (year-end 1987) level). Specifically, T would reduce the year-end 1988 reserve balance of $11,500 for the $2,500 actual loss and then add (and deduct) $1,000 to the reserve to restore the balance to the $10,000 base year amount. Thus, T's post-1987 PTI deduction of $1,500 is restored to income (i.e., T actually had losses of $2,500 in 1989, but only was allowed to deduct $1,000).

portion of the bad debt reserves that arose prior to 1988. The Congress believed that this relief should not directly benefit the shareholders of the institutions in a manner similar to the way in which prior-law section 593(e) provided a limitation on the direct enjoyment of the benefits of section 593 by shareholders of thrift institutions.

Further, because of the thrift industry's traditional role as home mortgage lenders, the Congress was concerned that the repeal of section 593 could have resulted in a temporary shortage in the availability of mortgage loans in some regions. The Congress addressed this issue by providing an incentive for institutions to continue to provide a level of residential mortgage financing for a period of time.

Explanation of Provision

Repeal of section 593

The Small Business Act repeals the section 593 reserve method of accounting for bad debts of thrift institutions, effective for taxable years beginning after 1995. Thrift institutions that would be treated as small banks [183] are allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks are required to use only the specific charge-off method. Thus, the percentage of taxable income method of accounting for bad debts is no longer available for any financial institution. The Small Business Act also repeals the following provisions that only applied to thrift institutions to which section 593 applied: (1) the denial of the use of a portion of certain tax credits by a thrift institution (sec. 50(d)(1)); (2) the special rules with respect to the foreclosure of property securing loans of a thrift institution (sec. 595); (3) the reduction in the dividends received deduction of a thrift institution (sec. 596); and (4) the ability of a thrift institution to use a net operating loss to offset its income from a residual interest in a REMIC (sec. 860E(a)(2)).

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts will treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury.[184] Any section 481(a) adjustment required to be taken into account with respect to such change generally will be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves shall be taken into account

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[183] Under section 581, the definition of a "bank" includes a thrift institution.

[184] The provisions of the Small Business Act will apply to a thrift institution that has a taxable year that begins after December 31, 1995, even if such taxable year is a short taxable year that comes to a close because the thrift institution is acquired by a non-thrift institution.

In addition, a thrift institution that uses a reserve method described in section 593 will be deemed to have changed its method of computing reserves for bad debts even though such institution will be allowed to use the reserve method of section 585. Similarly, a large thrift institution will be deemed to have changed its method of computing reserves for bad debts even though such institution used the experience-method portion of section 593 in lieu of the percentage-of-taxable-income method of section 593.

ratably over a six-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves generally is the excess of (1) the balance of its reserves described in section 593(c)(1) other than its supplemental reserve for losses on loans (i.e., its reserve for losses on qualifying real property loans and its reserve for losses on nonqualifying loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves (i.e., its reserve for losses on qualifying real property loans and its reserve for losses on nonqualifying loans) as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves").[185] Thus, a thrift institution that is treated as a large bank generally is required to recapture its post-1987 additions to its bad debt reserves, whether such additions are made pursuant to the percentage of taxable income method or the experience method. The timing of this recapture may be delayed for a one- or two-year period to the extent the residential loan requirement described below applies.

In the case of a thrift institution that becomes a "small bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves will be the excess of (1) the balance of its reserves described in section 593(c)(1) (other than the supplemental reserve) as of the close of its last taxable year beginning before January 1, 1996, over (2) the greater of the balance of: (a) its pre-1988 reserves or (b) what the institution's reserves would have been at the close of its last taxable year beginning before January 1, 1996, had the institution always used the experience method described in section 585(b)(2)(A) (i.e., the six-year average method). For purposes of the future application of section 585, the beginning balance of the small bank's reserve for its first taxable year beginning after December 31, 1995, will be the greater of the two amounts described in (2) in the preceding sentence, and the balance of the reserve at the close of the base year (for purposes of sec. 585(b)(2)(B)) will be the amount of its pre-1988 reserves. The residential loan requirement described below also applies to small banks. If such small bank later becomes a large bank, any section 481(a) adjustment amount required to be taken into account under section 585(c)(3) will not include any portion of the bank's pre-1988 reserve. Similarly, if the bank elects the cut-off method to implement its conversion to large bank status, the amount of the reserve against which the bank charges its actual losses will not include any portion of the bank's pre-1988 reserve and the amount by which the pre-1988 reserve exceeds actual losses will not be included in gross income.

The balance of the pre-1988 reserves is subject to the provisions of section 593(e), as modified by the Small Business Act (requiring recapture in the case of certain excess distributions to, and re-

[185] The balance of a taxpayer's pre-1988 reserves is reduced if the taxpayer's loan portfolio had decreased since 1988. The permitted balance of a taxpayer's pre-1988 reserves is reduced by multiplying such balance by the ratio of the balance of the taxpayer's loans outstanding at the close of the last taxable beginning before 1996, to the balance of the taxpayer's loans outstanding at the close of the last taxable beginning before 1988. This reduction is required for both large and small banks.

demptions of, shareholders). Thus, section 593(e) will apply to an institution regardless of whether the institution becomes a commercial bank or remains a thrift institution. In addition, the balances of the pre-1988 reserve and the supplemental reserve will be treated as tax attributes to which section 381 applies. Treasury regulations are expected to provide rules for the application of section 593(e) in the case of mergers, acquisitions, spin-offs, and other reorganizations of thrift and other institutions.[186] The Congress believed that any such regulations should provide that, if the stock of an institution with a pre-1988 reserve is acquired by another depository institution, the pre-1988 reserve will not be restored to income by reason of the acquisition. Similarly, if an institution with a pre-1988 reserve is merged or liquidated tax-free into a bank, the pre-1988 reserve should not be restored to income by reason of the merger or liquidation. Rather, the bank will inherit the pre-1988 reserve and the post-1951 earnings and profits of the former thrift institution and section 593(e) will apply to the bank as if it were a thrift institution. That is, the pre-1988 reserve will be restored into income in the case of any distribution in redemption of the stock of the bank or in partial or complete liquidation of the bank following the merger or liquidation. In the case of any other distribution, the pre-1988 reserve will not be restored to income unless the distribution is in excess of the sum of the post-1951 earnings and profits inherited from the thrift institution and the post-1913 earnings and profits of the acquiring bank.[187] It is expected that Treasury regulations will address the case where the shareholders of an institution with a pre-1988 reserve are "cashed out" in a taxable merger of the institution and a bank. Such regulations may provide that the pre-1988 reserve may be restored to income if such redemption represents a concealed distribution from the former thrift institution. For example, cash received by former thrift shareholders pursuant to a taxable reverse merger may represent a concealed distribution if, immediately preceding the merger, the acquiring bank had no available resources to distribute and its existing debt structure, indenture restrictions, financial condition, or regulatory capital requirements precluded it from borrowing money for purposes of making the cash payment to the former thrift shareholders. No inference was intended as to the application of section 593(e) to these and similar transactions under prior law.

Finally, if a taxpayer no longer qualifies as a bank (as defined by sec. 581), the balances of the taxpayer's pre-1988 reserve and supplemental reserves are restored to income ratably over a six-

[186] The Statement of Managers indicates that it is expected that in the case of the merger, acquisition, spin-off, or other reorganization involving only thrift institutions, section 593(e) as modified by the Small Business Act, will continue to be applied in a manner similar to the way section 593(e) is applied under present law.

However, guidance may be needed in the case of transactions where one of the parties to the transaction is not a thrift institution. Guidance may be needed because the issue of whether section 593(e) applies in the case where a thrift institution is merged into a bank generally did not arise under prior law because such merger resulted in a charter change and, under proposed Treasury regulations, required full bad debt reserve recapture.

[187] If the acquiring bank is a former thrift institution itself and the pre-1988 reserves of neither institution are restored to income pursuant to the merger, the it is expected that the pre-1988 reserves and the post-1951 earnings and profits of the two institutions will be combined for purposes of the continued application of section 593(e) with respect to the combined institution.

year period, beginning in the taxable year the taxpayer no longer qualifies as a bank.

Residential loan requirement

Under a special rule, if the taxpayer meets the "residential loan requirement" for a taxable year, the recapture of the applicable excess reserves otherwise required to be taken into account as a section 481(a) adjustment for such year will be suspended. A taxpayer meets the residential loan requirement if, for the taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. The residential loan requirement is applicable only for taxable years that begin after December 31, 1995, and before January 1, 1998, and must be applied separately with respect to each such year. Thus, all taxpayers are required to recapture their applicable excess reserves within six, seven, or eight years after the effective date of the provision.

The "base amount" of a taxpayer means the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount may be computed by disregarding the taxable years within that six-year period in which the principal amounts of loans made during such years were highest and lowest. This election must be made for the first taxable year beginning after December 31, 1995, and applies to the succeeding taxable year unless revoked with the consent of the Secretary of the Treasury or his delegate.

For purposes of the residential loan requirement, a loan will be deemed to be "made" by a financial institution to the extent the institution is, in fact, the principal source of the loan financing. Thus, any loan only can be "made" once. It is expected that loans "made" by a financial institution may include, but are not limited to, loans (1) originated directly by the institution through its place of business or its employees, (2) closed in the name of the institution, (3) originated by a broker that acts as an agent for the institution, and (4) originated by another person (other than a financial institution) and are acquired by the institution pursuant to a pre-existing, enforceable agreement to acquire such loans. In addition, Treasury regulations also may provide that loans "made" by a financial institution may include loans originated by another person (other than a financial institution) acquired by the institution soon after origination if such acquisition is pursuant to a customary practice of acquiring such loans from such person. A loan acquired by a financial institution from another financial institution generally will be considered to be made by the transferor rather than the transferee of the loan; however, such loan may be completely disregarded if a principal purpose of the transfer was to allow the transferor to meet the residential loan requirement. A loan may be considered to be made by a financial institution even if such institution has an arrangement to transfer such loan to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

For purposes of the residential loan requirement, a "residential loan" is a loan described in section 7701(a)(19)(C)(v) (generally, loans secured by residential real and church property and certain

mobile homes),[188] but only to the extent the loan is made to the owner of the property to acquire, construct, or improve the property. Thus, mortgage refinancings and home equity loans are not considered to be residential loans, except to the extent the proceeds of the loan are used to acquire, construct, or improve qualified residential real property. The Congress understood that pursuant to the Home Mortgage Disclosure Act, financial institutions are required to disclose the purpose for which loans are made. Furthermore, for purposes of this disclosure, institutions are required to classify loans as home purchase loans, home improvement loans, refinancings, and multifamily dwelling loans (whether for purchase, improvement or refinancing of such property). It is expected that taxpayers (and the Secretary of the Treasury in promulgating guidance) may take such reporting into account, and make such adjustments as are appropriate,[189] in determining: (1) whether or not a loan qualifies as a "residential loan" and (2) whether the institution "made" the loan. A taxpayer must use consistent standards for determining whether loans qualify as residential loans made by the institution both for purposes of determining its base amount and for purposes of determining whether it met the residential loan requirement for a taxable year.

The residential loan requirement is determined on a controlled group basis. Thus, for example, if a controlled group consists of two thrift institutions with applicable excess reserves that are wholly-owned by a bank, the residential loan requirement will be met (or not met) with respect to both thrift institutions by comparing the principal amount of the residential loans made by all three members of the group during the taxable year to the group's base amount. The group's base amount will be the average principal amount of residential loans made by all three members of the group during the base period. The election to disregard the high and low taxable years during the 6-year base period also would be applied on a controlled group basis (i.e., generally by treating the members of the group as one taxpayer so that all members of the group must join in the election, and the same corresponding years of each member would be so disregarded).

Treasury regulations may provide rules for the application of the residential loan requirement in the case of mergers, acquisitions, and other reorganizations of thrift and other institutions. For example, the balance of a taxpayer's applicable excess reserve will be treated as a tax attribute to which section 381 applies. Thus, if an institution with an applicable excess reserve is acquired in a tax-free reorganization, the Congress expected that the balance of such reserve will not be immediately restored to income but will continue to be subject to the residential loan requirement in the hands of the acquirer. It is further expected that if a financial institution

[188] For this purpose, as under present law, if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan will be deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). In addition, loans made to finance the acquisition or development of land will be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary of the Treasury, there is a reasonable assurance that the property will become residential real property within a period of three years from the date of acquisition of the land.

[189] For example, adjustments will be required with respect to the reporting of multifamily dwellings in order to distinguish home purchase, home improvement, and refinancing loans.

joins or merges into (or leaves) a group of financial institutions, the base amount of the acquiring (or remaining) group will be appropriately adjusted to reflect the base amount of the acquired (or departing) institution for purposes of determining whether the group meets the residential loan requirement for the year of the acquisition (or departure) and subsequent years. Similarly, if a controlled group of institutions had made an election to disregard its high and low years in computing its base amount, it is anticipated that such election shall be binding on any institution that subsequently joins the group and the election shall be applied to the new member by disregarding the high and low years of the new member even if such years do not correspond to the years applicable to the other members of the group.

Treatment of conversions to credit unions

The Small Business Act provides that if a thrift institution to which the repeal of section 593 applies becomes a credit union, the credit union will be treated as an institution that is not a bank and any section 481(a) adjustment required to be included in gross income will be treated as derived from an unrelated trade or business. Thus, if a thrift institution becomes a credit union in its first taxable year beginning after December 31, 1995, the entire balance of the institution's bad debt reserve will be included in income, and subject to tax, over a six-year period beginning with such taxable year. No inference is intended as to the Federal income tax treatment of any other aspect of the conversion of a financial institution to a credit union.

Effective Date

The repeal of section 593 is effective for taxable years beginning after December 31, 1995. The repeal of section 595 is effective for property acquired in taxable years beginning after December 31, 1995. The amendment to section 860E does not apply to any residual interest in a REMIC held by the taxpayer on October 31, 1995, and at all times thereafter.[190]

The amendment to section 593(e)(1)(B) does not apply to any distributions with respect to preferred stock (including redemptions of such stock) if: (1) such stock was issued and outstanding as of November 1, 1995, and at all times thereafter before the distribution and (2) such distribution is made within the later of (a) one year after the date of enactment of the Small Business Act or (b) if the stock is redeemable by the issuer or a related party, 30 days after the date such stock first may be redeemed. For this purpose, the first date a preferred stock may be redeemed is the day upon which the issuer or a related party has the right to call the stock, regardless of the amount of call premium.

Revenue Effect

The provision is estimated to increase fiscal year Federal budget receipts by $47 million in 1996, $111 million in 1997, $216 million in 1998, $280 million in 1999, $277 million in 2000, $272 million

[190] It is intended that this grandfather rule would not apply to REMIC residual interests held by a taxpayer that no longer qualifies as a bank.

in 2001, $260 million in 2002, $247 million in 2003, $111 million in 2004, $36 million in 2005, and $29 million in 2006.

18. Remove business exclusion for energy subsidies provided by public utilities (sec. 1617 of the Small Business Act and sec. 136 of the Code)

Present and Prior Law

Code section 136, as added by the Energy Policy Act of 1992, provides an exclusion from the gross income of a customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure with respect to a dwelling unit (as defined by sec. 280A(f)(1)). In addition, for subsidies received after 1994, section 136 provided a partial exclusion from gross income for the value of any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that was not a dwelling unit. The amount of the partial exclusion was 40 percent of the value for subsidies received in 1995, 50 percent of the value for subsidies received in 1996, and 65 percent of the value for subsidies received after 1996.

For purposes of section 136, an energy conservation measure is any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to property. With respect to property other than a dwelling unit, an energy conservation measure included "specially defined energy property" (generally, property described in sec. 48(l)(5) of the Code as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

The exclusion did not apply to payments made to or from a qualified cogeneration facility or a qualifying small power production facility pursuant to section 210 of the Public Utility Regulatory Policy Act of 1978.

Section 136 denies a deduction or credit to a taxpayer (or in appropriate cases requires a reduction in the adjusted basis of property of a taxpayer) for any expenditure to the extent that a subsidy related to the expenditure was excluded from the gross income of the taxpayer.

Reasons for Change

The Congress believed that the present-law exclusion for energy conservation subsidies may create biases against certain types of conservation programs and may be inappropriate in certain instances. However, the Congress believed the exclusion is appropriate for individual consumers because the taxation of such benefits may impose unduly harsh recordkeeping burdens with respect to these taxpayers. Thus, the Small Business Act only repeals the partial exclusion for subsidies with respect to nonresidential property.

Explanation of Provision

The Small Business Act repeals the partial exclusion for any subsidy provided by a utility for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit.

Effective Date

The provision is effective for subsidies received after December 31, 1996, unless received pursuant to a binding written contract in effect on September 13, 1995, and all times thereafter.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $63 million in 1997, $100 million in 1998, $104 million in 1999, $107 million in 2000, $109 million in 2001, $111 million in 2002, $113 million in 2003, $115 million in 2004, $116 million in 2005, and $117 million in 2006.

19. Treatment of financial asset securitization investment trusts ("FASITs") (sec. 1621 of the Small Business Act and secs. 26(b), 56(b), 382, 856(c), 860G, 1202(e), 7701, and new secs. 860H, 860I, 860J, 860K, 860L of the Code)

Prior Law

Under both prior and present law, an individual can own income-producing assets directly, or indirectly through an entity (i.e., a corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments that are securitized.

Entities used in securitization include entities that are subject to tax (e.g., a corporation), conduit entities that generally are not subject to tax (e.g., a partnership, grantor trust, or real estate mortgage investment conduit ("REMIC")), or partial-conduit entities that generally are subject to tax only to the extent income is not distributed to owners (e.g., a trust, real estate investment trust ("REIT"), or regulated investment company ("RIC")).

There was no statutory entity that facilitated the securitization of revolving, non-mortgage debt obligations.

Reasons For Change

The Congress believed that there are substantial benefits to the economy from increased securitization of assets in the form of debt because securitization of such assets will spread the risk of credit on the debt to others. The Congress believed that the spreading of credit risk will lessen the concentration of such risk in banks and

other financial intermediaries which, in turn, will lessen the pressure on Federal deposit insurance. Further, the Congress believed that the spreading of credit risk through securitization will result in lower interest rates for consumers.

The Congress understood that it was difficult to securitize revolving debt (such as credit card receivables) under prior law without the imposition of a corporate tax if the sponsor of the securitization did not want to report the securitized assets and the interests therein on his financial reports. Accordingly, the Small Business Act creates a new type of entity, known as a "financial asset securitization investment trust" or "FASIT," through which securitizations of all types of debt, including revolving credit debt, can be accomplished without the imposition of a corporate tax even though the securitized debt and the interests in the securitized debt are not reported on the financial statements of the securitization's sponsor.

Basically, the Small Business Act achieves its purpose by allowing the FASIT to issue instruments, called "regular interests," which will be treated as debt (and, therefore, payments of the return on such interests would be deductible as interest) even though such instruments might not otherwise be treated as debt for Federal income tax purposes. Nonetheless, in order that there be a corporate tax on returns that approach returns on equity, the Small Business Act requires that instruments whose yield is more than five percentage points higher than the yield on U.S. Treasury obligations (called "high-yield interests") be held, directly or indirectly, by domestic, non-exempt corporations and such yield cannot be offset by any net operating loss of its owner. In addition, in order to insure that FASITs are not used for purposes other than securitization, the Small Business Act imposes a 100-percent excise tax on any income not related to securitizations (i.e., income with respect to so-called "prohibited transactions").

Explanation of Provision

In general

The Small Business Act created a new type of statutory entity called a "financial asset securitization investment trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. The Congress expected that the Treasury Department will issue, prior to September 1, 1997, guidance on how this rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the FASIT. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing

yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

In general

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years; (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) have non-ownership interests be certain specified types of debt instruments called "regular interests"; (4) have a single ownership interest which is held by an "eligible holder"; and (5) not qualify as a RIC. Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

Election to be a FASIT

Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. The manner of making the election to be a FASIT is to determined by the Secretary of the Treasury. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time. As described below, a special transition rule is provided for entities in existence before the effective date that subsequently elect to be a FASIT.

Ceasing to be a FASIT

Once an entity ceases to be a FASIT, it is not a FASIT after the date of cessation and for any subsequent year. Nonetheless, an entity can continue to be a FASIT where the Treasury Department determines that the entity inadvertently ceased being FASIT, steps are taken reasonably soon after it is discovered that the entity ceased being a FASIT so that it again qualifies as a FASIT, and the FASIT and its owner take those steps that the Treasury Department deems necessary. An entity ceases qualifying as a FASIT if the entity's owner ceases being an eligible corporation. Loss of FASIT status is treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule which deems regular interests of a FASIT to be debt. The Congress understood that this treatment could result in the creation of cancellation of indebtedness income where the new instruments deemed to be issued are treated as stock under general tax principles.

Permitted assets

In general.—For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "per-

mitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. A FASIT must meet the asset test at the 90th day after its formation and at all times thereafter. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

Permitted debt instruments.—A debt instrument is a permitted asset only if the instrument is indebtedness for Federal income tax purposes including trade receivables, regular interests in a REMIC, or regular interests issued by another FASIT and it bears (1) fixed interest or (2) variable interest of a type that relates to qualified variable rate debt (as defined in Treasury regulations prescribed under sec. 860G(a)(1)(B)). Except for cash equivalents, permitted debt obligations cannot be obligations issued, directly or indirectly, by the owner of the FASIT or a related person.

Foreclosure property.—Permitted assets include property acquired on default (or imminent default) of debt instruments, swap contracts, forward contracts, or similar contracts held by the FASIT even though the acquired property is not real property that would be foreclosure property to a REIT (under sec. 856(e)) if the property that was acquired by foreclosure by the FASIT was real property or would be foreclosure property to a REIT but for certain leases entered into or construction performed (as described in sec. 856(e)(4)) while held by the FASIT. The Small Business Act grants the Treasury Secretary the power to reduce by regulations the two-year period that foreclosure property may be held as a permitted asset of the FASIT.

Hedges.—Permitted assets include interest rate or foreign currency notional principal contracts, letters of credit, insurance, guarantees against payment defaults, notional principal contracts that are "in the money," or other similar instruments as permitted under Treasury regulations, which are reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor of regular interests. An instrument is a hedge if it results in risk reduction as described in Treasury regulation section 1.1221-2. Under the Small Business Act, an asset which was a permitted asset at the time that it was acquired by the FASIT shall not be treated as an interest in the FASIT, except to the extent provided by regulation issued by the Treasury Secretary. Thus, an instrument acquired by the FASIT as a hedge (e.g., an interest rate swap) will not later become an interest in the FASIT when there is later an obligation by the FASIT to make payments to the counterparty under that hedge instrument.

"Regular interests" of a FASIT

Under the Small Business Act, "regular interests" of a FASIT, including "high-yield interests," are treated as debt for Federal income tax purposes regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity

under general tax principles.[191] To be treated as a "regular interest," an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) fixed rates or, (b) except as provided by regulations issued by the Treasury Secretary, variable rates permitted with respect to REMIC interests under section 860G(a)(1)(B)(i); (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of less than five percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued.

A FASIT also may issue high-yield debt interests, which includes any debt instrument issued by a FASIT that meets the second and third conditions described above, so long as such interests are not held by a disqualified holder. A "disqualified holder" generally is any holder other than (1) a domestic C corporation that does not qualify as a RIC, REIT, REMIC, or cooperative[192] or (2) a dealer who acquires FASIT debt for resale to customers in the ordinary course of business. An excise tax is imposed at the highest corporate rate on a dealer if there is a change in dealer status or if the holding of the instrument is for investment purposes. A 31-day grace period is granted before ownership of an interest held by a dealer generally could be treated as held by the FASIT owner for investment purposes. The Small Business Act provides that "interest-only instruments" ("IOs") may be issued by a FASIT as high-yield instruments if the instrument makes payments which consist of a specified portion of the interest payments in permitted assets and that portion does not vary throughout the life of that instrument.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to non-permitted holders of high-yield interests

A transfer of a high-yield interest to a disqualified holder is ignored for Federal income tax purposes. Thus, such a transferor will continue to be liable for any taxes due with respect to the transferred interest.

Taxation of a FASIT

In general

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the

[191] Regular interests, but not ownership interests, in a FASIT are treated as qualified assets where relevant (e.g., secs. 856, 860D, and 7701(a)(19)) if 95 percent or more of the assets of the FASIT are, at all times, qualified assets.

[192] Cooperatives are treated as disqualified holders because cooperatives, like RICs and REITs, are treated as pass-through entities and, also like the owners of RICs and REITs, the cooperative's members and patrons need not be C corporations.

FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec.165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. For this purpose, a FASIT's income does not include any income subject to the 100-percent penalty excise tax on prohibited transactions.

Income from prohibited transactions

The owner of a FASIT is required to pay a penalty excise tax equal to 100 percent of net income derived from (1) an asset that is not a permitted asset, (2) any disposition of an asset other than a permitted disposition, (3) any income attributable to loans originated by the FASIT, and (4) compensation for services (other than fees for a waiver, amendment, or consent under permitted assets not acquired through foreclosure). A permitted disposition is any disposition of any permitted asset (1) arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation); [193] (2) incident to the foreclosure, default, or imminent default of the asset; (3) incident to the bankruptcy or insolvency of the FASIT; (4) necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT; (5) to facilitate a clean-up call; (6) to substitute a permitted debt instrument for another such instrument; or (7) in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT. Notwithstanding this rule, the owner of a FASIT may currently deduct its losses incurred in prohibited transactions in computing its taxable income for the year of the loss.

Taxation of interests in the FASIT

Taxation of holders of regular interests

In general.—A holder of a regular interest, including a high-yield interest, is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.

High-yield interests.—Holders of high-yield interests are not allowed to use net operating losses to offset taxable income derived from the high-yield interests (including gain or loss from the sale of a high-yield interest in a FASIT). Any net operating loss carryover shall be computed by disregarding any income arising by reason of the disallowed loss.

[193] For this purpose, a "qualified liquidation" has the same meaning as it does purposes of the exemption from the tax on prohibited transactions of a REMIC in section 860F(a)(4).

In addition, a transfer of a high-yield interest to a disqualified holder is not recognized for Federal income tax purposes such that the transferor will continue to be taxed on the income from the high-yield interest unless the transferee provides the transferor with an affidavit that the transferee is not a disqualified person or the Treasury Secretary determines that the high-yield interest is no longer held by a disqualified person and a corporate tax has been paid on the income from the high-yield interest while it was held by a disqualified person.[194]

High-yield interests may be held without a corporate tax being imposed on the income from the high-yield interest where the interest is held by a dealer in securities who acquired such high-yield interest for sale in the ordinary course of his business as a securities dealer. In such a case, a corporate tax is imposed on such a dealer if his reason for holding the high-yield interest changes to investment. There is a presumption that the dealer has not changed his intent for holding high-yield instruments to investment for the first 31 days he holds such interests unless such holding is part of a plan to avoid the restriction on holding of high-yield interests by disqualified persons.

Where a pass-through entity (other than a FASIT) issues either debt or equity instruments that are secured by regular interests in a FASIT and such instruments bear a yield to maturity greater than the yield on the regular interests and the AFR plus five percentage points (determined on the date that the pass-through entity acquires the regular interests in the FASIT) and a principal purpose of such arrangement is the avoidance of the restriction that high-yield interests be held by qualified holders, then an excise tax[195] is imposed on the pass-through entity at a rate equal to the highest corporate rate on the income of any holder of such instrument attributable to the regular interests.

Taxation of holder of ownership interest

All of the FASIT's assets and liabilities are treated as assets and liabilities of the holder of a FASIT ownership interest and that owner takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is included in the income of the holder as ordinary income.

Losses on assets contributed to the FASIT are not allowed upon their contribution, but may be allowed to the FASIT owner upon their disposition by the FASIT. A special rule provides that the holder of a FASIT ownership interest cannot offset taxable income from the FASIT ownership interest (including gain or loss from the sale of the ownership interest in the FASIT) with losses. Any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss. Where the holder the a FASIT ownership interest is a member of

[194] Under this rule, no high-yield interests will be treated as issued where the FASIT directly issues such interests to a disqualified holder.

[195] A technical correction may be necessary in order for this tax to be treated as an excise tax for purposes of the procedural rules of Subtitle F.

a consolidated group, this rule applies to the consolidated group of corporations of which the holder is a member as if the group were a single taxpayer. In addition, the Small Business Act coordinates the rule that limits a taxpayer's ability to offset REMIC excess inclusion income against net operating losses with this similar rule under the FASIT provisions.

For purposes of the alternative minimum tax, the owner's taxable income is determined without regard to the minimum FASIT income. The alternative minimum taxable income of the FASIT owner cannot be less than the FASIT income for that year, and the alternative minimum tax net operating loss deduction is computed without regard to the minimum FASIT income.

For purposes of the wash sale rule (sec. 1091), an ownership interest of a FASIT is treated as a "security." In addition, an ownership interest in a FASIT and a residual interest in a pool of debt obligations that are substantially similar to the debt obligations in the FASIT are treated as "substantially identical stock or securities." Finally, the wash sale period begins six months before, and ends six months after, the sale of the ownership interest of the FASIT.

Transfers to FASITs

Gain generally is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Where property is acquired by a FASIT from someone other than the FASIT's owner (or a person related to the FASIT's owner), the property is treated as being first acquired by the FASIT's owner for the FASIT's cost in acquiring the asset from the non-owner and then transferred by the owner to the FASIT.

In addition, any assets of the FASIT owner or a related person that are used to support [196] FASIT regular interests are treated as contributed to the FASIT and, thus, any gain on any such assets also will be recognized at the earliest date that such assets support any FASIT's regular interests. Where the assets which support a regular interest in the FASIT are held by a person related to the owner of the FASIT, the gain will be deemed realized to that related person.

To the extent provided by Treasury regulations, gain recognition on the contributed assets may be deferred until such assets support regular interests issued by the FASIT or any indebtedness of the owner or related person. These regulations may adjust other statutory FASIT provisions to the extent such provisions are inconsistent with such regulations. For example, such regulations may disqualify certain assets as permitted assets. The basis of any FASIT asset is increased by the amount of the taxable gain recognized on the contribution of the assets to the FASIT.

[196] For this purpose, supporting assets includes any assets that are reasonably expected to directly or indirectly pay regular interests or to otherwise secure or collateralize regular interests. In the case where there is a commitment to make additional contributions to a FASIT, any such assets will not be treated as supporting the FASIT until they are transferred to the FASIT or set aside for such use.

Valuation rules

In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. In the case of debt instruments that are traded on an established securities market, then the market price will be used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. Nonetheless, the Small Business Act contains special rules for valuing other debt instruments for purposes of computing gain on the transfer to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations. For purposes of determining the value of a pool of revolving loan accounts having substantially the same terms, each extension of credit (other than the accrual of interest) is treated as a separate debt instrument and the maturity of the instruments is determined using the reasonably anticipated periodic payment rate at which principal payments will be made as a proportion of their aggregate outstanding principal balances assuming that payments are applied to the earliest credit extensions. The Congress understood that reasonably expected cash flows from loans will reflect nonpayment (i.e., losses), early payments (i.e., prepayments), and reasonable costs of servicing the loans. This value is used in determining the amount of gain realized upon the contribution of assets to a FASIT even though that value may be different than the value of such assets would be applying a willing buyer/willing seller standard.

If section 475 applies to securities before their transfer (or deemed transfer) to a FASIT, except as provided in Treasury regulations, section 475 will continue to apply to the securities after the transfer (or deemed transfer). In such cases, the amount realized shall be the greater of the securities' value under section 475 or their value determined under the special valuation rules applicable to FASITs.

Related person

For purposes of the FASIT rules, a person is related to another person if that person bears a relationship to the other person specified in sections 267(b) or 707(b)(1), using a 20-percent ownership test instead of the 50-percent test, or such persons are engaged in trades or businesses under common control as determined under sections 52(a) or (b).

Effective Date

The provision takes effect on September 1, 1997. The Small Business Act provides a special transition rule for entities in existence on August 31, 1997, (e.g., a trust whose interests are taxed like a partnership) that elect to be a FASIT (called a "pre-effective date FASIT"). Under the special transitional rule, gain is not recognized on property contributed, or deemed contributed, to the FASIT to the extent that any such property is allocable to interests issued by a "pre-effective date FASIT" (called a "pre-FASIT interest"). The

portion of such property that is allocable to "pre-FASIT interests" is to be determined by the Treasury Secretary, except that the property of the entity allocable to "pre-FASIT interests" shall not be less than 107 percent of the aggregate principal amounts of outstanding "pre-FASIT interests."

Revenue Effect

The provision was estimated to increase Federal fiscal year budget receipts by $92 million in 1998, $48 million in 1999, and $8 million in 2000, and reduce such receipts by $3 million in 2001, $9 million in 2002, $14 million in 2003, $19 million in 2004, $25 million in 2005 and $32 million in 2006.

20. Modify treatment of foreign trusts (secs. 1901-1907 of the Small Business Act and secs. 643, 665, 668, 672, 679, 901, 1491, 1494, 6038, 6039F, 6048, 6677, 7701 and 7872 of the Code)

Prior Law

Grantor trusts

Grantor trusts with foreign grantors

Under the prior law grantor trust rules (secs. 671-679), a grantor that retained certain rights or powers generally was treated as the owner of the trust's assets without regard to whether the grantor was a domestic or foreign person. Under these rules, U.S. trust beneficiaries were not subject to U.S. tax on distributions from a trust where a foreign grantor was treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction. A special rule provided that if a U.S. beneficiary of an inbound grantor trust transferred property to the foreign grantor by gift, that U.S. beneficiary was treated as the grantor of the trust to the extent of the transfer (sec. 672(f)).

Grantor trusts with U.S. grantors

A U.S. person that transfers property to a foreign trust generally is treated as the owner of the portion of the trust attributable to that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust (sec. 679(a)). This treatment generally does not apply, however, to transfers by reason of death. In addition, under prior law, this treatment did not apply to transfers made before the transferor became a U.S. person, or to transfers that represented sales or exchanges of property at fair market value where gain was recognized to the transferor.

Distributions of income accumulated by foreign nongrantor trusts

Accumulation distribution rules

The accumulation distribution rules (secs. 656-668) generally apply to distributions from a trust in excess of the trust's distributable net income for the taxable year. Under prior law, a distribution by a foreign nongrantor trust of previously accumulated income generally was taxed at the U.S. beneficiary's average mar-

ginal rate for the prior 5 years, plus interest (secs. 666 and 667). Interest was computed at a fixed annual rate of 6 percent, with no compounding (sec. 668). If adequate records of the trust were not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution was treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)). A special rule provided, in effect, that intermediaries or nominees interposed between certain foreign trusts and U.S. beneficiaries were disregarded. This special rule treated any amount paid from a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust that was created by a U.S. person, as if paid to the recipient directly by the foreign trust (sec. 665(c)).

Loans to beneficiaries

Under prior law, if a foreign nongrantor trust made a loan to one of its beneficiaries, the principal of such a loan generally was not taxable as income to the beneficiary.

Residence of trusts

Definition

Under prior law, a trust was treated as foreign if it was not subject to U.S. income taxation on its income that was neither derived from U.S. sources nor effectively connected with the conduct of a U.S. trade or business (sec. 7701(a)(31)). Thus, if a trust was taxed in a manner similar to a nonresident alien individual, it was considered to be a foreign trust. Any other trust was treated as domestic.

Change in a trust's residence

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust. However, under prior law, in the case of a domestic trust that changed its situs and became a foreign trust, it was unclear whether property had been transferred from a U.S. person to a foreign entity and, thus, whether the transfer was subject to the excise tax.

Information reporting and penalties related to foreign trusts

Reporting requirements

Any U.S. person that creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department without regard to whether the trust is a grantor trust or a nongrantor trust (sec. 6048). Under prior law, any U.S. person that transferred property to a foreign trust that had one or more U.S. beneficiaries was required to report annually to the Treasury Department. Under prior law, there was no requirement to report distributions from a foreign trust.

In addition, regulations require any U.S. person that makes a transfer described in section 1491 to report the transfer to the Treasury Department.

Applicable penalties

Under prior law, any person that failed to file a required report with respect to the creation of, or a transfer to, a foreign trust could be subject to a penalty of 5 percent of the amount transferred to the foreign trust (sec. 6677). Similarly, any person that failed to file a required annual report with respect to a foreign trust with U.S. beneficiaries could be subject to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case could not exceed $1,000. A reasonable cause exception was available.

Reporting of foreign gifts

There was no requirement to report gifts or bequests from foreign sources under prior law.

Reasons for Change

Grantor trust rules

Grantor trusts with foreign grantors

The Congress was informed that prior law's U.S. grantor trust provisions were being used as a vehicle to avoid U.S. tax. Under the grantor trust rules, only the owner of the trust (and not the trust's beneficiaries) is subject to U.S. tax on the trust's income. Thus, under prior law, if a foreign person created a trust with U.S. beneficiaries that was treated as a grantor trust for U.S. tax purposes and if the foreign person's home country did not tax the income, the income of the trust would not be subject to tax by either the United States or the foreign country. The Congress believed that the income derived through these types of arrangements should be subject to tax by at least one jurisdiction.

Grantor trusts with U.S. grantors

The Congress understood that taxpayers were able to avoid the application of the outbound grantor trust rules of section 679. For example, a transfer of property to a foreign trust could be structured as a sale in exchange for a note issued by the trust or a person related to the trust where the note would not be repaid. The Congress believed that it is appropriate to disregard notes that do not reflect arm's-length terms in determining whether the transferor received fair market value for the property transferred.

Distributions of income accumulated by foreign nongrantor trusts

Accumulation distribution rules

The 6-percent simple interest charge applicable to accumulation distributions from a foreign nongrantor trust had not been updated since 1976. In essence, income earned through a foreign nongrantor trust could be deferred from U.S. taxation, then subjected to a below-market interest rate when distributed to a U.S. beneficiary. The Congress believed that it is appropriate to charge the same rate of interest on accumulation distributions as is applicable to general underpayments of income tax.

Loans to beneficiaries

Under prior law, a U.S. beneficiary of a foreign trust could avoid U.S. tax on the income accumulated through the trust by obtaining a "loan" of cash or marketable securities from the trust in lieu of an actual distribution. The Congress believed that it is appropriate to treat loans that do not reflect arm's-length terms as distributions to the borrower.

Residence of trusts

Because the U.S. tax treatment of a trust (and the beneficiaries of a trust) depends on the residence of the trust, the Congress believed that it is appropriate to provide objective criteria for determining the residence of trusts.

Information reporting requirements and associated penalties

The Congress was informed that certain U.S. settlors established foreign trusts, including grantor trusts, in tax haven jurisdictions. Income from such foreign grantor trusts was taxable on a current basis to the U.S. grantor, but the Congress understood that there was noncompliance in this regard. The Congress was concerned that the prior-law civil penalties for failure to comply with the reporting requirements applicable to foreign trusts established by U.S. persons had proven to be ineffective. In order to deter noncompliance, the Congress believed that it is appropriate to expand the reporting requirements relating to activities of foreign trusts with U.S. grantors or U.S. beneficiaries and to increase the civil penalties applicable to a failure to comply with such reporting requirements.

The Congress understood that some of the jurisdictions in which U.S. settlors established foreign trusts have strict secrecy laws. The Congress was concerned that the secrecy laws may effectively preclude the Treasury Department from obtaining information necessary to determine the tax liabilities of the U.S. grantors or U.S. beneficiaries with respect to items related to such foreign trusts. The Congress believed that it is useful, in the case of a foreign trust with a U.S. grantor, to provide an incentive for the trust to have a limited U.S. agent to accept service of process in order to improve the administrability of the tax law applicable to taxation of income derived from foreign trusts.

Explanation of Provisions

Grantor trusts

Grantor trusts with foreign grantors

The Small Business Act generally applies the grantor trust rules only to the extent such application results, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. This rule does not prevent a trust that does not have any income in a year from being treated as a grantor trust provided that income of the trust would be currently includible by a U.S. person if the trust had income. Certain exceptions apply to this rule. Under one exception, the grantor trust rules continue to

apply to the portion of a trust where that portion of the trust is revocable by the grantor either without approval of another person or with the consent of a related or subordinate party who is subservient to the grantor. Under another exception, the grantor trust rules continue to apply to the portion of a trust where the only amounts distributable from that portion during the lifetime of the grantor are to the grantor or the grantor's spouse. The general rule denying grantor trust status does not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995 provided that such a trust is treated as owned by the grantor under section 676 or 677 (other than sec. 677(a)(3)).[197] In addition, except as provided in regulations, the grantor trust rules continue to apply where the grantor is a controlled foreign corporation (as defined in sec. 957). Finally, except as provided in regulations, the grantor trust rules continue to apply in determining whether a foreign corporation is characterized as a passive foreign investment company ("PFIC"). Thus, a foreign corporation cannot avoid PFIC status by transferring its assets to a grantor trust.

If a U.S. beneficiary of an inbound trust transfers property to the foreign "grantor," such beneficiary generally is treated as a grantor of a portion of the trust to the extent of the transfer. This rule applies if, but for section 672(f), the foreign grantor otherwise is treated as the owner of any portion of such trust. However, this rule does not apply if the transfer is a sale of the property for full and adequate consideration or if the transfer is a gift that qualifies for the annual exclusion described in section 2503(b).

The Small Business Act provides a special rule that allows the Secretary of the Treasury to recharacterize a transfer, directly or indirectly, from a partnership or foreign corporation which the transferee treats as a gift or bequest, to prevent the avoidance of the purpose of section 672(f) (e.g., the transfer may be recharacterized as a trust distribution).[198] The Small Business Act treats any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust of which the payor is not the grantor, as if paid by the foreign trust directly to the U.S. person. This rule disregards the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike prior law, however, the rule applies regardless of whether the trust was created by a U.S. person. The rule does not apply to a withdrawal from a foreign trust by its grantor, followed by a subsequent gift or other payment to a U.S. person.

In the case where a foreign person (that would be treated as the owner of a trust but for the rules of sec. 672(f)) actually pays tax on the income of the trust to a foreign country, the Congress anticipated that Treasury regulations will provide that, for foreign tax credit purposes, U.S. beneficiaries that are subject to U.S. income tax on the same income will be treated as having paid the foreign taxes that are paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

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[197] The exception does not apply to the portion of any such trust attributable to any transfers to the trust made after September 19, 1995.

[198] See discussion below for reporting requirements under the Small Business Act with respect to certain foreign gifts and bequests received by a U.S. person.

Grantor trusts with U.S. grantors

The Small Business Act makes the following modifications to the rule which treats a U.S. person that transfers property to a foreign trust as the owner of the portion of the trust attributable to the transferred property for any taxable year in which there is a U.S. beneficiary of the trust (sec. 679(a)):

(1) *Sales or exchanges at market value.*—The Small Business Act modifies the prior law exception to the grantor trust treatment under section 679(a)(1) to provide that, except as provided in regulations, obligations issued (or, to the extent provided by regulations, guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary[199] (referred to as "trust obligations") generally are not taken into account in determining whether fair market value is received for property transferred to a trust by any grantor or beneficiary of the trust, or any person related to any grantor or beneficiary. The Congress expected that Treasury regulations will provide an exception from this treatment for loans with arm's-length terms. In applying this exception, the Congress further expected that consideration be given to whether there is a reasonable expectation that a loan will be repaid. Principal payments by the trust on any such trust obligations generally will reduce the portion of the trust of which the transferor is treated as the grantor.

(2) *Other transfers.*—The Small Business Act adds a new exception to the general rule of section 679(a)(1). Under that exception, a transfer of property to certain charitable trusts is exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries as grantor trusts.

(3) *Transferors who become U.S. persons.*—The Small Business Act applies the rule of section 679(a)(1) to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally is treated as making a transfer to the foreign trust on the individual's U.S. residency starting date (as defined in sec. 7701(b)(2)(A)). The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, such a person generally is treated under section 679(a)(1) as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries.

(4) *Beneficiaries who become U.S. persons.*—Under the Small Business Act, a beneficiary is not treated as a U.S. person for purposes of determining whether the transferor of property to a foreign trust is taxed as a grantor with respect to any portion of a foreign trust if such beneficiary first became a U.S. person more than 5 years after the transfer.

(5) *Outbound trust migrations.*—The Small Business Act applies the rule of section 679(a)(1) to a U.S. citizen or resident who trans-

[199] For this purpose, a person is treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b), except that in applying section 267(c)(4) an individual's family includes the spouses of the members of the family.

ferred property to a domestic trust if the trust subsequently becomes a foreign trust while the transferor is still alive. Such a person is deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, such a person generally is treated under the rules of section 679(a)(1) as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries.

(6) *Technical amendment*.—The Small Business Act conforms the definition of certain foreign corporations the income of which is deemed to be accumulated for the benefit of a U.S. beneficiary to the definition of controlled foreign corporations (as defined in sec. 957(a)).

Distributions of income accumulated by foreign nongrantor trusts

Accumulation distribution rules

The Small Business Act changes the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the same manner as interest imposed on underpayments of tax under section 6621(a)(2). Simple interest is accrued at the rate of 6 percent through 1995. Beginning on January 1, 1996, however, compound interest based on the underpayment rate is imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution is allocated proportionately to prior trust years in which the trust has undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution is treated as reducing proportionately the undistributed net income from prior years.

The Small Business Act contains a formula to determine the number of years for which interest is charged on each accumulation distribution. Basically, interest is imposed under the formula for the dollar-weighted number of years that taxation of the accumulated income was deferred (the "applicable number of years"). This dollar-weighted number of years is computed by dividing (a) the product of multiplying the dollar amount of undistributed income for a particular year by the number of years from the year of the accumulation of such income until the year of the accumulation distribution (counting the taxable year in which the accumulated income was recognized, but not counting (1) the taxable year in which the distribution was made and (2) any taxable year during which the trust beneficiary who received the accumulation distribution was not a citizen or resident of the United States) by (b) the aggregate amount of undistributed net income of the trust. The number of years resulting from this formula gives the number of years' interest that is payable computed as if the distributed income had been earned measured back from the date of the distribution by the number of years resulting from the formula. For exam-

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ple, if a foreign nongrantor trust has undistributed net income of $30 for each of years 1 through 3 and the trust makes an accumulation distribution of $45 to a U.S. beneficiary in year 4, the beneficiary has to pay interest on the tax on the $45 using section 6621(a)(2) interest rates as if the income accrued for 2 years.[200] In addition, the accumulation distribution reduces the trust's undistributed net income by $15 for each of years 1 through 3 for purposes of computing the amount of any future accumulation distribution and the applicable number of years attributable to such accumulation distribution.[201]

Loans to beneficiaries

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary[202]), the Small Business Act treats the full amount of the loan as a distribution to the grantor or beneficiary except to the extent provided by Treasury regulations. The Congress expected that Treasury regulations will provide an exception from this treatment for loans with arm's-length terms. In applying this exception, the Congress further expected that consideration be given to whether there is a reasonable expectation that a loan will be repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) is disregarded for all purposes of the Code. This provision does not apply to loans made to persons that are exempt from U.S. income tax.

Anti-abuse regulatory authority

The Small Business Act includes an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to estates, trusts and beneficiaries, including regulations to prevent the avoidance of those purposes.

Residence of trusts

Definition

The Small Business Act establishes a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. A trust is treated as domestic if it meets the two following requirements: (1) a U.S. court (e.g., State, or local) exercises primary supervision over the administration of the trust, and (2) one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. In applying the second factor, it is intended that a trust be allowed a reasonable period of time to adjust for any inadvertent changes in the trust's fiduciaries.

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[200] The number of years is determined as follows:
($30×3 years)+($30×2 years)+($30×1 year)÷$90=2

[201] That is, the $45 of distribution reduces proportionately the undistributed net income for each of years 1, 2 and 3.

[202] For this purpose, a person is treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b), except that in applying section 267(c)(4) an individual's family includes the spouses of the members of the family.

Change in a trust's residence

Under the Small Business Act, if a domestic trust changes its situs and becomes a foreign trust, the trust is treated as having made a transfer of its assets to a foreign trust and is subject to the 35-percent excise tax imposed by section 1491 unless one of the exceptions to this excise tax is applicable.

Information reporting and penalties

Foreign trust reporting

The Small Business Act generally requires the grantor, transferor or executor (i.e., the "responsible party") to file information returns with the Treasury Department upon the occurrence of certain "reportable events." The term "reportable event" generally means the creation of any foreign trust by a U.S. person, the direct and indirect transfer of any money or property to a foreign trust, including a transfer by reason of death, and the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of the trust or any portion of a foreign trust was included in the gross estate of the decedent. In addition, the U.S. owner of any portion of a foreign trust generally is required to ensure that the trust files an annual return to provide full accounting of all the trust activities for the taxable year. Finally, any U.S. person that receives (directly or indirectly) any distribution from a foreign trust is required to file a return to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe. A special rule provides that a U.S. trust that has substantial foreign activities or holds substantial foreign property shall be treated, to the extent provided in regulations, as a foreign trust for purposes of the Small Business Act's rules with respect to information reporting and associated penalties. In exercising its regulatory authority to treat a U.S. trust as a foreign trust for purposes of the information reporting provisions, the Congress expected that the Secretary of the Treasury will take into account the information that such a trust reports under the domestic trust reporting rules.

Applicable penalties

Under the Small Business Act, a person that fails to provide the required notice or return in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, is subject to an initial penalty equal to 35 percent of the gross reportable amount (generally the value of the property involved in the transaction). A U.S. owner's failure to provide an annual reporting of trust activities will result in an initial penalty equal to 5 percent of the gross reportable amount. An additional $10,000 penalty is imposed on the responsible party for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. In no event will the total amount of penalties exceed the gross reportable amount. Such penalties are subject to a reasonable cause exception. Where an amount that is less than the full gross amount is reported, the penalties will be applied based on the amount that is unreported.

The Small Business Act provides comparable penalties for any failure to file a return required by the Secretary of the Treasury with respect to any transfer described in section 1491 to any foreign entity. For purposes of applying the penalties for failure to report a section 1491 transfer, it is anticipated that the Secretary of the Treasury will take into account information reported under other provisions of the Code in determining whether the reporting requirements have been satisfied with respect to the section 1491 transfer.

Appointment of limited U.S. agent

The Small Business Act provides that if a U.S. owner of any portion of a foreign trust fails to appoint a limited U.S. agent to accept service of process with respect to any requests and summons by the Secretary of the Treasury in connection with the tax treatment of any items related to the trust, the Treasury Secretary may determine the tax consequences of amounts to be taken into account under the grantor trust rules. The Congress intended that the Treasury Secretary's exercise of its authority to make such a determination will be subject to judicial review under an arbitrary or capricious standard, which provides a high degree of deference to such determination. In cases where adequate records are not provided to the Treasury Secretary to determine the proper treatment of any distributions from a foreign trust, the distribution is includible in the gross income of the U.S. distributee and is treated as an accumulation distribution from the middle year of a foreign trust (i.e., computed by taking the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution, unless the foreign trust elects to have a U.S. agent for the limited purpose of accepting service of process (as described above).

Reporting of foreign gifts

The Small Business Act generally requires any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than $10,000 during the taxable year to report them to the Treasury Department. The threshold amount for this reporting requirement is indexed for inflation. The definition of a gift to a U.S. person for this purpose excludes amounts that are qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)(2)), and amounts that are distributions to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the reporting requirements of the Small Business Act. If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Secretary of the Treasury is authorized to determine the tax treatment of the unreported gifts. The Congress intended that the Treasury Secretary's exercise of its authority to make such a determination will be subject to judicial review under an arbitrary or capricious standard, which provides a high degree of deference to such determination. In addition, the U.S. person is subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

Effective Dates

Grantor trust rules

Grantor trusts with foreign grantors

The provisions that generally treat grantor trusts with foreign grantors as nongrantor trusts are effective on August 20, 1996 (the date of enactment of the Small Business Act). The Small Business Act provides a transition rule for any domestic trust that has a foreign person that is treated as the owner of the trust under prior law, but becomes a nongrantor trust under the Small Business Act. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust is exempt from the excise tax on transfers to a foreign trust otherwise imposed by section 1491. However, the Small Business Act's new reporting requirements and penalties are applicable to such a trust and its beneficiaries. The assets of a trust that is treated as a grantor trust under prior law but that becomes a nongrantor trust under the Small Business Act will be treated as if they were recontributed to a nongrantor trust by the foreign grantor, with no recognition of gain or loss, on the date the trust ceases to be treated as a grantor trust. The nongrantor trust will have the same basis in such assets as did the owner on the date the trust ceases to be treated as a grantor trust.

Grantor trusts with U.S. grantors

The amendments to section 679 apply to transfers of property after February 6, 1995.

Distributions of income accumulated by foreign nongrantor trust

The provision to modify the interest charge on accumulation distributions applies to distributions after August 20, 1996. The provision with respect to loans to U.S. grantors, U.S. beneficiaries or a U.S. person related to such a grantor or beneficiary applies to loans made after September 19, 1995.

Anti-abuse regulatory authority

The provision is effective on August 20, 1996.

Residence of trusts

The provision to modify the treatment of a trust as a U.S. person applies to taxable years beginning after December 31, 1996. The Internal Revenue Service has announced procedures under which a U.S. trust in existence on August 20, 1996 may continue to file returns as a U.S. trust for taxable years beginning after December 31, 1996 if the trustee initiates modification of the trust to conform to the new U.S. trust criteria by the due date for filing the trust's return for its first taxable year beginning after 1996, the trustee completes the modification within two years of such date, and the

trustee attaches the required statement to the trust returns for the taxable years beginning after 1996.[203]

If the trustee of a trust so elects, the provision to modify the treatment of a trust as a U.S. person may be applied to the first taxable year ending after August 20, 1996. Notice 96-65 includes guidance regarding the time and manner for making this election. When a trustee makes this election, and as a result changes the situs of a trust from domestic to foreign, the trust is treated as having made an outbound transfer of its assets upon becoming a foreign trust. Consequently, the section 1491 excise tax will apply to such a transfer.

The amendment to section 1491 is effective on August 20, 1996. Notice 96-65 includes guidance regarding the application of section 1491 to a trust the status of which changes from U.S. to foreign by reason of the provisions modifying the treatment of a trust as a U.S. person.

Reporting requirements

The provisions to amend reporting requirements and applicable penalties generally apply to reportable events or transfers occurring or distributions received after August 20, 1996. The annual reporting requirement and penalties applicable to U.S. grantors apply to taxable years of such persons beginning after December 31, 1995. The Internal Revenue Service has announced that it intends to provide detailed guidance with respect to the information reporting requirements applicable to reportable events (under sec. 6048(a)) and other transfers subject to comparable penalties (under sec. 1494(c)) before 1997.[204] Notice 96-60 suspends the requirement to file an information return under section 6048(a) until a date that is at least 60 days after the issuance of the forthcoming guidance. Any information return submitted within the time period set forth in such guidance will be considered filed on a timely basis. Similarly, no penalty will be imposed under section 1494(c) if a return required with respect to a section 1491 transfer is filed no later than 60 days after the issuance of the forthcoming guidance (or such later date specified in that guidance). The gift reporting rules are to apply to amounts received after August 20, 1996.

Revenue Effect

The provisions are estimated to increase Federal fiscal year budget receipts by $52 million in 1996, $143 million in 1997, $171 million in 1998, $180 million in 1999, $188 million in 2000, $197 million in 2001, $206 million in 2002, $214 million in 2003, $223 million in 2004, $245 million in 2005, and $260 million in 2006.

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[203] See Notice 96-65, I.R.B. 1996-52. The approach reflected in Notice 96-65 may require a technical correction.

[204] See Notice 96-60, 1996-49 I.R.B. 7.

VI. TAX TECHNICAL CORRECTIONS PROVISIONS

The technical corrections subtitle of the Small Business Act contains clerical, conforming and clarifying amendments to the provisions enacted by the Revenue Reconciliation Act of 1990 ("1990 Act"), the Revenue Reconciliation Act of 1993 ("1993 Act"), and other recently enacted legislation. All amendments made by this subtitle are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment. Except as otherwise described, the amendments made by the technical corrections subtitle take effect as if included in the original legislation to which each amendment relates.

A. Technical Corrections to the Revenue Reconciliation Act of 1990

1. Excise tax provisions

a. Application of the 2.5-cents-per-gallon tax on fuel used in rail transportation to States and local governments (sec. 1702(b)(2) of the Small Business Act, sec. 11211(b)(4) of the 1990 Act, and sec. 4093 of the Code)

Present and Prior Law

The 1990 Act increased the highway and motorboat fuels taxes by 5 cents per gallon, effective on December 1, 1990. The 1990 Act continued the exemption from these taxes for fuels used by States and local governments.

The 1990 Act further imposed a 2.5-cents-per-gallon tax on fuel used in rail transportation, also effective on December 1, 1990. Because of a drafting error, the 2.5-cents-per-gallon tax on fuel used in rail transportation incorrectly applies to fuel used by States and local governments.

Explanation of Provision

The Small Business Act clarifies that the 2.5-cents-per-gallon tax on fuel used in rail transportation does not apply to such uses by States and local governments.

b. Small winery production credit and bonding requirements (secs. 1702(b)(5), (6), and (7) of the Small Business Act, sec. 11201 of the 1990 Act, and sec. 5041 of the Code)

Prior Law

A 90-cents-per-gallon credit is allowed to wine producers who produce no more than 250,000 gallons of wine in a year. The credit may be claimed against the producers' excise or income taxes.

Wine producers must post a bond in amounts determined by reference to expected excise tax liability as a condition of legally operating.

Explanation of Provision

The Small Business Act clarifies that wine produced by eligible small wineries may be transferred without payment of tax to bonded warehouses that become liable for payment of the wine excise tax without losing credit eligibility. In such cases, the bonded warehouse will be eligible for the credit to the same extent as the producer otherwise would have been.

The Small Business Act further clarifies that the Treasury Department has broad regulatory authority to prevent the benefit of the credit from accruing (directly or indirectly) to wineries producing in excess of 250,000 gallons in a calendar year.

Congress intended that the Treasury regulatory authority extend to all circumstances in which wine production is increased with a purpose of securing indirect credit eligibility for wine produced by such large producers.

The Small Business Act also clarifies that the Treasury Department may take the amount of credit expected to be claimed against a producer's wine excise tax liability into account in determining the amount of required bond.

2. Other revenue-increase provisions of the 1990 Act

a. Deposits of Railroad Retirement Tax Act taxes (sec. 1702(c)(3) of the Small Business Act, sec. 11334 of the 1990 Act, and sec. 6302(g) of the Code)

Prior Law

Employers must deposit income taxes withheld from employees' wages and FICA taxes that are equal to or greater than $100,000 by the close of the next banking day. Under the Railroad Retirement Solvency Act of 1983, the deposit rules for withheld income taxes and FICA taxes automatically apply to Railroad Retirement Tax Act taxes (sec. 226 of P.L. 98-76).

Explanation of Provision

The Small Business Act conforms the Internal Revenue Code to the Railroad Retirement Solvency Act of 1983 by stating in the Code that these deposit rules for withheld income taxes and FICA taxes apply to Railroad Retirement Tax Act taxes.

b. Treatment of salvage and subrogation of property and casualty insurance companies (sec. 1702(c)(4) of the Small Business Act and sec. 11305 of the 1990 Act)

Prior Law

For taxable years beginning after December 31, 1989, property and casualty insurance companies are required to reduce the deduction allowed for losses incurred (both paid and unpaid) by estimated recoveries of salvage and subrogation attributable to such losses. In the case of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, 87 percent of the discounted amount of the estimated salvage and subrogation recoverable as of the close of the last taxable year beginning before January 1, 1990, is allowed as a deduction ratably over the first 4 taxable years beginning after December 31, 1989. This special deduction was enacted in order to provide such property and casualty insurance companies with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that, prior to the Revenue Reconciliation Act of 1990, did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

Explanation of Provision

The Small Business Act provides that the earnings and profits of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, is to be determined without regard to the special deduction that is allowed over the first 4 taxable years beginning after December 31, 1989. The special deduction is to be taken into account, however, in determining earnings and profits for purposes of applying sections 56, 902, and subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1986. This provision is considered necessary in order to provide those property and casualty insurance companies that took into account estimated salvage and subrogation recoverable in determining losses incurred with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that, prior to the 1990 Act, did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

c. Information with respect to certain foreign-owned or foreign corporations: Suspension of the statute of limitations during certain judicial proceedings (sec. 1702(c)(5) of the Small Business Act, secs. 11314 and 11315 of the 1990 Act, and secs. 6038A and 6038C of the Code)

Prior Law

Any domestic corporation that is 25-percent owned by one foreign person is subject to certain information reporting and record-keeping requirements with respect to transactions carried out directly or indirectly with certain foreign persons treated as related to the domestic corporation ("reportable transactions") (sec. 6038A(a)). In addition, the Code provides procedures whereby an IRS examination request or summons with respect to reportable transactions can be served on foreign related persons through the domestic corporation (sec. 6038A(e)). Similar provisions apply to any foreign corporation engaged in a trade or business within the United States, with respect to information, records, examination requests, and summonses pertaining to the computation of its liability for tax in the United States (sec. 6038C). Certain noncompliance rules may be applied by the Internal Revenue Service in the case of the failure by a domestic corporation to comply with a summons pertaining to a reportable transaction (a "6038A summons") (sec. 6038A(e)), or the failure by a foreign corporation engaged in a U.S. trade or business to comply with a summons issued for purposes of determining the foreign corporation's liability for tax in the United States (a "6038C summons") (sec. 6038C(d)).

Any corporation that is subject to the provisions of section 6038A or 6038C has the right to petition a Federal district court to quash a 6038A or 6038C summons, or to review a determination by the IRS that the corporation did not substantially comply in a timely manner with the 6038A or 6038C summons (sec. 6038A(e)(4)(A) and (B); sec. 6038C(d)(4)). During the period that either such judicial proceeding is pending (including appeals), and for up to 90 days thereafter, the statute of limitations is suspended with respect to any transaction (or item, in the case of a foreign corporation) to which the summons relates (secs. 6038A(e)(4)(D), 6038C(d)(4)).

The legislative history of the 1989 Act amendments to section 6038A states that the suspension of the statute of limitations applies to "the taxable year(s) at issue."[205] The legislative history of the 1990 Act, which added section 6038C to the Code, uses the same language.[206]

Explanation of Provision

The Small Business Act modifies the provisions in sections 6038A and 6038C that suspend the statute of limitations to clarify

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[205] H. Rept. No. 247, 101st Cong., 1st Sess. 1301 (1989); "Explanation of Provisions Approved by the Committee on October 3, 1989," Senate Finance Committee Print, 101st Cong., 1st Sess. 118 (October 12, 1989).

[206] "Legislative History of Ways and Means Democratic Alternative," House Ways and Means Committee Print (WMCP: 101-37), 101st Cong., 2nd Sess. 58 (October 15, 1990); Report language submitted by the Senate Finance Committee to the Senate Budget Committee on S. 3299, 136 Cong. Rec. S 15629, S 15700 (1990).

that the suspension applies to any taxable year the determination of the amount of tax imposed for which is affected by the transaction or item to which the summons relates.

Congress intended that, under the provision, a transaction or item would affect the determination of the amount of tax imposed for the taxable year directly at issue, as well as for any taxable year indirectly affected through, for example, net operating loss carrybacks or carryforwards. Congress did not intend that, under the provision, a transaction or item would affect the determination of the amount of tax imposed for any taxable year other than the taxable year directly at issue solely by reason of any similarity of issues involved. Similarly, Congress did not intend that, under the provision, a transaction or item would affect the determination of the amount of tax imposed on any taxpayer unrelated to the taxpayer to whom the summons is directed.

d. Rate of interest for large corporate underpayments (secs. 1702(c)(6) and (7) of the Small Business Act, sec. 11341 of the 1990 Act, and sec. 6621(c) of the Code)

Prior Law

The rate of interest otherwise applicable to underpayments of tax is increased by two percent in the case of large corporate underpayments (generally defined to exceed $100,000), applicable to periods after the 30th day following the earlier of a notice of proposed deficiency, the furnishing of a statutory notice of deficiency, or an assessment notice issued in connection with a nondeficiency procedure.

Explanation of Provision

The Small Business Act provides that an IRS notice that is later withdrawn because it was issued in error does not trigger the higher rate of interest. The Small Business Act also corrects an incorrect reference to "this subtitle".

3. Research credit provision: Effective date for repeal of special proration rule (sec. 1702(d)(1) of the Small Business Act and sec. 11402 of the 1990 Act)

Prior Law

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months by prorating certain qualified research expenses incurred before January 1, 1991. The special rule to prorate qualified research expenses applied in the case of any taxable year which began before October 1, 1990, and ended after September 30, 1990. Under this special proration rule, the amount of qualified research expenses incurred by a taxpayer prior to January 1, 1991, was multiplied by the ratio that the number of days in that taxable year before October 1, 1990, bears to the total number of days in such taxable year before January 1, 1991. The amendments made by the 1989 Act to the research credit (including the new method for calculating a taxpayer's base amount) generally were effective for taxable years be-

ginning after December 31, 1989. However, this effective date did not apply to the special proration rule (which applied to any taxable year which began prior to October 1, 1990—including some years which began before December 31, 1989—if such taxable year ended after September 30, 1990).

Section 11402 of the Revenue Reconciliation Act of 1990 ("1990 Act") extended the research credit through December 31, 1991, and repealed the special proration rule provided for by the 1989 Act. Section 11402 of the 1990 Act was effective for taxable years beginning after December 31, 1989. Thus, in the case of taxable years beginning before December 31, 1989, and ending after September 30, 1990 (e.g., a taxable year of November 1, 1989 through October 31, 1990), the special proration rule provided by the 1989 Act would continue to apply.

Explanation of Provision

The Small Business Act repeals for all taxable years ending after December 31, 1989, the special proration rule provided for by the 1989 Act.

4. Energy tax provision: Alternative minimum tax adjustment based on energy preferences (secs. 1702(e)(1) and (4) of the Small Business Act, sec. 11531(a) of the 1990 Act, and former sec. 56(h) of the Code)

Prior Law

In computing alternative minimum taxable income (and the adjusted current earnings (ACE) adjustment of the alternative minimum tax), certain adjustments are made to the taxpayer's regular tax treatment for intangible drilling costs (IDCs) and depletion. For certain taxable years, a special energy deduction is also allowed. The special energy deduction is initially determined by determining the taxpayer's (1) intangible drilling cost preference and (2) the marginal production depletion preference. The intangible drilling cost preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to the adjustments for IDCs. The marginal production depletion preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to depletion adjustments attributable to marginal production. The intangible drilling cost preference is then apportioned between (1) the portion of the preference related to qualified exploratory costs and (2) the remaining portion of the preference. The portion of the preference related to qualified exploratory costs is multiplied by 75 percent and the remaining portion is multiplied by 15 percent. The marginal production depletion preference is multiplied by 50 percent. The three products described above are added together to arrive at the taxpayer's special energy deduction (subject to certain limitations).

The special energy deduction is not allowed to the extent that it exceeds 40 percent of alternative minimum taxable income determined without regard to either this special energy deduction or the alternative tax net operating loss deduction. Any special energy deduction amount limited by the 40-percent threshold may not be

carried to another taxable year. In addition, the combination of the special energy deduction, the alternative minimum tax net operating loss and the alternative minimum tax foreign tax credit cannot generally offset, in the aggregate, more than 90 percent of a taxpayer's alternative minimum tax determined without such attributes.

The special energy deduction was repealed for taxable years beginning after December 31, 1992.

Explanation of Provision

Interaction of special energy deduction with net operating loss and investment tax credit

The Small Business Act clarifies that the amount of alternative tax net operating loss that is utilized in any taxable year is to be appropriately adjusted to take into account the amount of special energy deduction claimed for that year. This operates to preserve a portion of the alternative tax net operating loss carryover by reducing the amount of net operating loss utilized to the extent of the special energy deduction claimed, which if unused, could not be carried forward.

In addition, the Small Business Act contains a similar provision which clarifies that the limitation on the utilization of the investment tax credit for purposes of the alternative minimum tax is to be determined without regard to the special energy deduction.

Interaction of special energy deduction with adjustment based on adjusted current earnings

The Small Business Act provides that the ACE adjustment for taxable years beginning in 1991 and 1992 is to be computed without regard to the special energy deduction. Thus, the Small Business Act specifies that the ACE adjustment is equal to 75 percent of the excess of a corporation's adjusted current earnings over its alternative minimum taxable income computed without regard to either the ACE adjustment, the alternative tax net operating loss deduction, or the special energy deduction.

5. Estate tax freezes (sec. 1702(f) of the Small Business Act, sec. 11602 of the 1990 Act, and secs. 2701-2704 of the Code)

Prior Law

Generally

The value of property transferred by gift or includible in the decedent's gross estate is its fair market value. Fair market value generally is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031). Chapter 14 contains rules that supersede the willing buyer, willing seller standard (Code secs. 2701-2704).

Preferred interests in corporations and partnerships

Valuation of retained interests

Scope.—Section 2701 provides special rules for valuing certain rights retained in conjunction with the transfer to a family member of an interest in a corporation or partnership. These rules apply to any applicable retained interest held by the transferor or an applicable family member immediately after the transfer of an interest in such entity. An "applicable family member" is, with respect to any transferor, the transferor's spouse, ancestors of the transferor and the spouse, and spouses of such ancestors.

An applicable retained interest is an interest with respect to which there is one of two types of rights ("affected rights"). The first type of affected right is a liquidation, put, call, or conversion right, generally defined as any liquidation, put, call, or conversion right, or similar right, the exercise or nonexercise of which affects the value of the transferred interest. The second type of affected right is a distribution right[207] in an entity in which the transferor and applicable family members hold control immediately before the transfer. In determining control, an individual is treated as holding any interest held by the individual's brothers, sisters and lineal descendants. A distribution right does not include any right with respect to a junior equity interest.

Valuation.—Section 2701 contains two rules for valuing applicable retained interests. Under the first rule, an affected right other than a right to qualified payments is valued at zero. Under the second rule, any retained interest that confers (1) a liquidation, put, call or conversion right and (2) a distribution right that consists of the right to receive a qualified payment is valued on the assumption that each right is exercised in a manner resulting in the lowest value for all such rights (the "lowest value rule"). There is no statutory rule governing the treatment of an applicable retained interest that confers a right to receive a qualified payment, but with respect to which there is no liquidation, put, call or conversion right.

A qualified payment is a dividend payable on a periodic basis and at a fixed rate under cumulative preferred stock (or a comparable payment under a partnership agreement). A transferor or applicable family member may elect not to treat such a dividend (or comparable payment) as a qualified payment. A transferor or applicable family member also may elect to treat any other distribution right as a qualified payment to be paid in the amounts and at the times specified in the election.

Inclusion in transfer tax base.—Failure to make a qualified payment valued under the lowest value rule within four years of its due date generally results in an inclusion in the transfer tax base equal to the difference between the compounded value of the scheduled payments over the compounded value of the payments actually made. The Treasury Department has regulatory authority to make subsequent transfer tax adjustments in the transfer of an ap-

[207] Distribution right generally is a right to a distribution from a corporation with respect to its stock, or from a partnership with respect to a partner's interest in the partnership.

plicable retained interest to reflect the increase in a prior taxable gift by reason of section 2701.

Generally, this inclusion occurs if the holder transfers by sale or gift the applicable retained interest during life or at death. In addition, the taxpayer may, by election, treat the payment of the qualified payment as giving rise to an inclusion with respect to prior periods.

The inclusion continues to apply if the applicable retained interest is transferred to an applicable family member. There is no inclusion on a transfer of an applicable retained interest to a spouse for consideration or in a transaction qualifying for the marital deduction, but subsequent transfers by the spouse are subject to the inclusion. Other transfers to applicable family members result in an immediate inclusion as well as subjecting the transferee to subsequent inclusions.

Minimum value of residual interest

Section 2701 also establishes a minimum value for a junior equity interest in a corporation or partnership. For partnerships, a junior equity interest is an interest under which the rights to income and capital are junior to the rights of all other classes of equity interests.

Trusts and term interests in property

The value of a transfer in trust is the value of the entire property less the value of rights in the property retained by the grantor. Section 2702 provides that in determining the extent to which a transfer of an interest in trust to a member of the transferor's family is a gift, the value of an interest retained by the transferor or an applicable family member is zero unless such interest takes certain prescribed forms.

For a transfer with respect to a specified portion of property, section 2702 applies only to such portion. The section does not apply to the extent that the transfer is incomplete.

Options and buy-sell agreements

A restriction upon the sale or transfer of property may reduce its fair market value. Treasury regulations provide that a restriction is to be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than full and adequate consideration (Treas. Reg. sec. 20.2031-2(h)).

Section 2703 provides, that for transfer tax purposes, the value of property is determined without regard to any option, agreement or other right to acquire or use the property at less than fair market value or any restriction on the right to sell or use such property. Certain options are excepted from this rule. To fall within the exception, the option, agreement, right or restriction must (1) be a bona fide business arrangement, (2) not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (3) have terms comparable to similar arrangements entered into by persons in an arm's length transaction.

Explanation of Provision

Preferred interests in corporations and partnerships

Valuation

The Small Business Act provides that an applicable retained interest conferring a distribution right to qualified payments with respect to which there is no liquidation, put, call, or conversion right is valued without regard to section 2701. The Small Business Act also provides that the retention of such right gives rise to potential inclusion in the transfer tax base. In making these changes, Congress understood that Treasury regulations could provide, in appropriate circumstances, that a right to receive amounts on liquidation of the corporation or partnership constitutes a liquidation right within the meaning of section 2701 if the transferor, alone or with others, holds the right to cause liquidation.

The Small Business Act modifies the definition of junior equity interest by granting regulatory authority to treat a partnership interest with rights that are junior with respect to either income or capital as a junior equity interest. The Small Business Act also modifies the definition of distribution right by replacing the junior equity interest exception with an exception for a right under an interest that is junior to the rights of the transferred interest. As a result, section 2701 does not affect the valuation of a transferred interest that is senior to the retained interest, even if the retained interest is not a junior equity interest.

The Small Business Act modifies the rules for electing into or out of qualified payment treatment. A dividend payable on a periodic basis and at a fixed rate under a cumulative preferred stock held by the transferor is treated as a qualified payment unless the transferor elects otherwise. If held by an applicable family member, such stock is not treated as a qualified payment unless the holder so elects.[208] In addition, a transferor or applicable family member holding any other distribution right may treat such right as a qualified payment to be paid in the amounts and at the times specified in the election.

Inclusion in transfer tax base

The Small Business Act grants the Treasury Department regulatory authority to make subsequent transfer tax adjustments to reflect the inclusion of unpaid amounts with respect to a qualified payment. This authority, for example, would permit the Treasury Department to eliminate the double taxation that might occur if, with respect to a transfer, both the inclusion and the value of qualified payment arrearages were included in the transfer tax base. It also would permit elimination of the double taxation that might result from a transfer to a spouse, who, under the statute, is both an applicable family member and a member of the transferor's family.

The Small Business Act treats a transfer to a spouse falling under the annual exclusion the same as a transfer qualifying for

[208] With respect to gifts made prior to the date of enactment, the provision provides that this election may be made by the due date (including extensions) of the transferor's gift tax return due for the first calendar year after the date of enactment.

the marital deduction. Thus, no inclusion would occur upon the transfer of an applicable retained interest to a spouse, but subsequent transfers by the spouse would be subject to inclusion. The Small Business Act also clarifies that the inclusion continues to apply if an applicable family member transfers a right to qualified payments to the transferor.

The provision clarifies the consequences of electing to treat a distribution as giving rise to an inclusion. Under the Small Business Act, the election gives rise to an inclusion only with respect to the payment for which the election is made. The inclusion with respect to other payments is unaffected.

Trust and term interests in property

The Small Business Act conforms section 2702 to existing regulatory terminology by substituting the term "incomplete gift" for "incomplete transfer." In addition, the Small Business Act limits the exception for incomplete gifts to instances in which the entire gift is incomplete. The Treasury Department is granted regulatory authority, however, to create additional exceptions not inconsistent with the purposes of the section. This authority, for example, could be used to except a charitable remainder trust that meets the requirements of section 664 and that does not otherwise create an opportunity for transferring property to a family member free of transfer tax.

6. Miscellaneous provisions

a. Conforming amendments to the repeal of the *General Utilities* doctrine (secs. 1702(g)(1) and (2) of the Small Business Act, sec. 11702(e)(2) of the 1990 Act, and secs. 897(f) and 1248 of the Code)

Prior Law

As a result of changes made by recent tax legislation, gain is generally recognized on the distribution of appreciated property by a corporation to its shareholders. The Technical Corrections subtitle of the 1990 Act and technical correction provisions in prior acts made various conforming amendments arising out of these changes. For example, the 1990 Act made a conforming change to section 355(c) to state the treatment of distributions in section 355 transactions in the affirmative rather than by reference to the provisions of section 311. In addition, the Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") made a conforming change to section 1248(f) to update the references to the nonrecognition provisions contained in that subsection. One of the changes was to change the reference to "section 311(a)" from "section 311".

Explanation of Provision

The Small Business Act makes three conforming changes to the Code with respect to the repeal of the *General Utilities* doctrine.

First, section 1248(f) is amended to add a reference to section 355(c)(1), which provides generally for the nonrecognition of gain or loss on the distribution of stock or securities in certain subsidiary corporations. This retains the substance of the law as it existed be-

fore the conforming change to section 355(c) made by the 1990 Act. This provision is not intended to affect the authority of the Secretary of the Treasury to issue regulations under section 1248(f) providing exceptions to the rule recognizing gain in certain distributions (cf. Notice 87-64, 1987-2 C.B. 375).

Second, section 1248 is amended to clarify that, notwithstanding the conforming changes made by the 1988 Act, with respect to any transaction in which a U.S. person is treated as realizing gain from the sale or exchange of stock of a controlled foreign corporation, the U.S. person shall be treated as having sold or exchanged the stock for purposes of applying section 1248. Thus, if a U.S. person distributes appreciated stock of a controlled foreign corporation to its shareholders in a transaction in which gain is recognized under section 311(b), section 1248 shall be applied as if the stock had been sold or exchanged at its fair market value. Under section 1248(a), part or all of the gain may be treated as a dividend. Under the Small Business Act, the rule treating the distribution for purposes of section 1248 as a sale or exchange also applies where the U.S. person is deemed to distribute the stock under the provisions of section 1248(i). Under section 1248(i), gain will be recognized only to the extent of the amount treated as a dividend under section 1248.

Third, section 897(f), relating to the basis in a United States real property interest distributed to a foreign person, is repealed as deadwood. The basis of the distributed property is its fair market value in accordance with section 301(d).

b. Prohibited transaction rules (sec. 1702(g)(3) of the Small Business Act, sec. 11701(m) of the 1990 Act, and sec. 4975 of the Code)

Prior Law

The Code and title I of the Employee Retirement Income Security Act of 1974 (ERISA) prohibit certain transactions between an employee benefit plan and certain persons related to such plan. An exemption to the prohibited transaction rules of title I of ERISA is provided in the case of sales of employer securities the plan is required to dispose of under the Pension Protection Act of 1987 (ERISA sec. 408(b)(12)). The 1990 Act amended the Code to provide that certain transactions that are exempt from the prohibited transaction rules of ERISA are automatically exempt from the prohibited transaction rules of the Code. The 1990 Act change was intended to be limited to transactions exempt under section 408(b)(12) of ERISA.

Explanation of Provision

The Small Business Act conforms the statutory language to legislative intent by providing that transactions that are exempt from the prohibited transaction rules of ERISA by reason of ERISA section 408(b)(12) are also exempt from the prohibited transaction rules of the Code.

c. Effective date of LIFO adjustment for purposes of computing adjusted current earnings (sec. 1702(g)(4) of the Small Business Act, sec. 11701 of the 1990 Act, sec. 7611(b) of the 1989 Act, and sec. 56(g) of the Code)

Prior Law

For purposes of computing the adjusted current earnings (ACE) component of the corporate alternative minimum tax, taxpayers are required to make the LIFO inventory adjustments provided in section 312(n)(4) of the Code. Section 312(n)(4) generally is applicable for purposes of computing earnings and profits in taxable years beginning after September 30, 1984. The ACE adjustment generally is applicable to taxable years beginning after December 31, 1989.

Explanation of Provision

The Small Business Act clarifies that the LIFO inventory adjustment required for ACE purposes shall be computed by applying the rules of section 312(n)(4) only with respect to taxable years beginning after December 31, 1989. The effective date applicable to the determination of earnings and profits (September 30, 1984) is inapplicable for purposes of the ACE LIFO inventory adjustment. Thus, the ACE LIFO adjustment shall be computed with reference to increases (and decreases, to the extent provided in Treasury regulations) in the ACE LIFO reserve in taxable years beginning after December 31, 1989.

d. Low-income housing credit (sec. 1702(g)(5) of the Small Business Act, sec. 11701(a)(11) of the 1990 Act, and sec. 42 of the Code)

Prior Law

The amendments to the low-income housing tax credit contained in the Omnibus Budget Reconciliation Act of 1989 ("1989 Act") generally were effective for buildings placed in service after December 31, 1989, to the extent the buildings were financed by tax-exempt bonds ("bond-financed buildings"). This rule applied regardless of when the bonds were issued.

A technical correction enacted in the 1990 Act limited this effective date to buildings financed with bonds issued after December 31, 1989. Thus, the technical correction applied pre-1989 Act law to bond-financed buildings placed in service after December 31, 1989, if the bonds were issued before January 1, 1990.

Explanation of Provision

The Small Business Act repeals the 1990 Act technical correction. The Small Business Act provides, however, that pre-1989 Act law will apply to a bond-financed building if the owner of the building establishes to the satisfaction of the Secretary of the Treasury reasonable reliance upon the 1990 Act technical correction. In the case of buildings placed in service before the date of the Small Business Act's enactment, reasonable reliance may be established by a showing of compliance with the law as in effect for those

buildings before enactment of the amendments made by the Small Business Act.

7. Expired or obsolete provisions ("deadwood provisions") (secs. 1702(h)(1)-(19) of the Small Business Act and secs. 11801-11816 of the 1990 Act)

Prior Law

The 1990 Act repealed and amended numerous sections of the Code by deleting obsolete provisions ("deadwood"). These amendments were not intended to make substantive changes to the tax law.

Explanation of Provision

The Small Business Act makes several amendments to restore the substance of prior law which was inadvertently changed by the deadwood provisions of the 1990 Act. These amendments include (1) a provision that clarifies that solar or wind property owned by a public utility may qualify as 5-year MACRS property (sec. 168(e)(3)(B)(vi)); (2) a provision restoring the prior-law rule providing that if any member of an affiliated group of corporations elects the credit under section 901 for foreign taxes paid or accrued, then all members of the group paying or accruing such taxes must elect the credit in order for any dividend paid by a member of the group to qualify for the 100-percent dividends received deduction (sec. 243(b)); and (3) a provision that denies section 179 expensing for property described in section 50(b) and air conditioning and heating units.

The Small Business Act also makes several nonsubstantive clerical amendments to conform the Code to the amendments made by the deadwood provisions. None of these amendments is intended to change the substance of pre-1990 law.

B. Technical Corrections to the Revenue Reconciliation Act of 1993

1. Treatment of full-time students under the low-income housing credit (sec. 1703(b)(1) of the Small Business Act, sec. 13142 of the 1993 Act and sec. 42 of the Code)

Prior Law

The 1993 Act codified prior law rules relating to the treatment of married students filing joint returns. Further, it provided that a housing unit occupied entirely by full-time students may qualify for the credit if the full-time students are a single parent and his or her minor children and none of the tenants is a dependent of a third party.

Explanation of Provision

The Small Business Act provides that the full-time student provision is effective on the date of enactment of the 1993 Act.

2. Indexation of threshold applicable to excise tax on luxury automobiles (sec. 1703(c) of the Small Business Act, sec. 13161 of the 1993 Act, and sec. 4001(e)(1) of the Code)

Prior Law

The 1993 Act indexed the threshold above which the excise tax on luxury automobiles is to apply.

Explanation of Provision

The Small Business Act corrects the application of the indexing adjustment so that the adjustment calculated for a given calendar year applies for that calendar year rather than in the subsequent calendar year. This conforms the indexation to that described in the conference report to the 1993 Act.[209] The intent of Congress, as reflected in the conference report, was that current year indexation be effective on the date of enactment of the 1993 Act. Under the Small Business Act, the provision would, however, be effective on the date of enactment, to alleviate the difficulties that both taxpayers and the Treasury would experience in administering a retroactive refund effective to August 10, 1993.

3. Indexation of the limitation based on modified adjusted gross income for income from United States Savings bonds used to pay higher education tuition and fees (sec. 1703(d) of the Small Business Act, sec. 13201 of the 1993 Act, and sec. 135(b)(2)(B) of the Code)

Prior Law

A taxpayer may exclude from gross income the proceeds from the redemption of qualified United States savings bonds if the proceeds are used to pay qualified higher education expenses and the taxpayer's modified adjusted gross income is equal to or less than $60,000 ($40,000 in the case of a single return). The exclusion is phased out for incomes above these thresholds. The $60,000 ($40,000) threshold is indexed for inflation occurring after 1992.

Explanation of Provision

The Small Business Act corrects the indexing of the $60,000 ($40,000) threshold to provide that the thresholds be indexed for inflation after 1989, as was provided prior to the 1993 Act.

4. Reporting and notification requirements for lobbying and political expenditures of tax-exempt organizations (sec. 1703(g) of the Small Business Act, sec. 13222 of the 1993 Act and sec. 6033(e) of the Code)

Prior Law

Tax-exempt organizations which incur political expenditures are subject to tax under Code section 527(f). The tax is calculated by applying the highest corporate rate to the lesser of (a) the net investment income of the organization, or (b) the amount of political

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[209] See, H. Rept. 103-213, August 4, 1993, p. 558.

expenditures incurred by the organization during the taxable year. Expenditures covered by Code section 527(f) are those expended for "influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed."

Code section 162(e), as amended by the 1993 Act, provides a separate set of rules regarding the tax treatment of lobbying and political expenditures. Political expenditures include amounts paid or incurred in connection with "participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office." Taxpayers may not deduct the portion of dues or similar amounts paid to a tax-exempt organization which the organization notifies the taxpayer are allocable to lobbying or political expenditures.

Code section 6033(e) sets forth reporting and notification requirements applicable to tax-exempt organizations (other than charities) that incur lobbying or political expenditures within the meaning of Code section 162(e). First, the organization must report on its annual tax return both the total amount of its lobbying and political expenditures, and the total amount of dues (or similar payments) allocable to such expenditures. Second, the organization must either provide notice to its members of the portion of dues allocable to lobbying and political expenditures (so that such amounts are not deductible by members), or may elect to pay a proxy tax (at the highest corporate rate) on its lobbying and political expenditures, up to the amount of dues receipts.

Explanation of Provision

The Small Business Act amends Code section 6033(e) to clarify that any political expenditures on which tax is paid pursuant to Code section 527(f) are not subject to the reporting and notification requirements of Code section 6033(e). In addition, the Small Business Act clarifies that the reporting and notification requirements of Code section 6033(e) apply only to organizations exempt from tax under Code section 501(a) (other than charities described in section 501(c)(3)).

5. Estimated tax rules for certain tax-exempt organizations (sec. 1703(h) of the Small Business Act, sec. 13225 of the 1993 Act and sec. 6655(g)(3) of the Code)

Prior Law

A tax-exempt organization is generally subject to an addition to tax for any underpayment of estimated tax on its unrelated business taxable income or its net investment income (as the case may be). Under the 1993 Act, for years beginning after December 31, 1993, a corporation or tax-exempt organization does not have an underpayment of estimated tax if it makes four timely estimated tax payments that total at least 100 percent of the tax liability shown on its return for the current taxable year. A corporation or tax-exempt organization may estimate its current year tax liability

prior to year-end by annualizing its income. The 1993 Act also changed the method by which a corporation annualizes its current year tax liability.

Explanation of Provision

The Small Business Act clarifies that the 1993 Act did not change the method by which a tax-exempt organization annualizes its current year tax liability.

6. Current taxation of certain earnings of controlled foreign corporations—application of foreign tax credit limitation (sec. 1703(i)(1) of the Small Business Act, sec. 13231(b) of the 1993 Act, and sec. 904(d) of the Code)

Prior Law

Prior and present law requires U.S. shareholders of a controlled foreign corporation to include in income the corporation's subpart F income, certain earnings invested in U.S. property, and, as modified by the 1993 Act, certain earnings invested in excess passive assets. A U.S. shareholder's tax liability attributable to the inclusion may be offset by foreign tax credits for certain foreign taxes paid or deemed paid by the shareholder.

The foreign tax credit limitation applies separately to several categories of income. The separate limitations apply to a dividend from a controlled foreign corporation to a U.S. shareholder of that controlled foreign corporation by reference to the character of the earnings and profits of the distributing corporation.

An inclusion of a controlled foreign corporation's earnings invested in U.S. property is treated like a dividend for purposes of the foreign tax credit limitation. Although the 1993 Act provided that inclusions of earnings invested in excess passive assets generally are determined in the same manner as inclusions of earnings invested in U.S. property, the 1993 Act did not specify how the separate limitations of the foreign tax credit should apply to inclusions of earnings invested in excess passive assets.

Some have argued that the separate limitations of the foreign tax credit do not apply to an inclusion of a controlled foreign corporation's earnings invested in excess passive assets; rather, that such an inclusion is allocated entirely to the general foreign tax credit limitation, without regard to the character of the underlying earnings and profits of the controlled foreign corporation.

Explanation of Provision

The Small Business Act clarifies that a U.S. shareholder's inclusion of a controlled foreign corporation's earnings invested in excess passive assets is treated like a dividend for purposes of the foreign tax credit limitation. Thus, the inclusion is characterized by reference to the underlying earnings and profits of the controlled foreign corporation. This treatment is consistent with present law's application of the separate limitations of the foreign tax credit to other amounts included in income with respect to a controlled foreign corporation.

7. Current taxation of certain earnings of controlled foreign corporations—measurement of accumulated earnings (sec. 1703(i)(2) of the Small Business Act, sec. 13231(b) of the 1993 Act, and sec. 956A(b) of the Code)

Prior Law

Prior and present law, as modified by the 1993 Act, limits the availability of deferral of U.S. tax on certain earnings of controlled foreign corporations by requiring U.S. shareholders of a controlled foreign corporation to include in income the corporation's accumulated[210] or current earnings invested in excess passive assets. Some have argued that the Code's definition of earnings subject to this treatment permits an accumulated deficit in earnings to eliminate positive current earnings, resulting in no income inclusion in a case where an actual distribution would be treated as a dividend out of current earnings. In addition, some have argued that the Code's definition of earnings subject to this treatment takes current-year earnings into account more than once.

Explanation of Provision

The Small Business Act clarifies that the accumulated earnings and profits of a controlled foreign corporation taken into account for purposes of determining the foreign corporation's earnings invested in excess passive assets do not include any deficit in accumulated earnings and profits,[211] and do not include current earnings (which are taken into account separately).

8. Current taxation of certain earnings of controlled foreign corporations—aggregation and look-through rules (sec. 1703(i)(3) of the Small Business Act, sec. 13231(b) of the 1993 Act, and sec. 956A(f) of the Code)

Prior Law

Prior and present law, as modified by the 1993 Act, provides certain aggregation and look-through rules in connection with requiring U.S. shareholders of a controlled foreign corporation to include in income certain of the corporation's earnings invested in excess passive assets. Under the aggregation rule, certain groups of controlled foreign corporations that are linked by stock ownership of more than 50 percent (CFC groups) are treated as a single corporation for purposes of determining their earnings invested in excess passive assets. Look-through treatment applies to certain corporations whose stock is owned at least 25 percent by a controlled foreign corporation. Some have argued that these rules permit the assets of one foreign corporation to be taken into account more than once through a combination of CFC group treatment and look-through treatment. In addition, some have argued that these rules permit the assets of one foreign corporation to be taken into account more than once through membership of the foreign corporation in more than one CFC group.

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[210] Accumulated earnings and profits are taken into account only to the extent that they were accumulated in taxable years beginning after September 30, 1993.

[211] Incurred in taxable years beginning after September 30, 1993.

Explanation of Provision

The Small Business Act clarifies that, within the regulatory authority provided to the Secretary of the Treasury under the 1993 Act, regulations are specifically authorized to coordinate the CFC group treatment and look-through treatment applicable for purposes of determining a foreign corporation's earnings invested in excess passive assets. Pending the promulgation of guidance by the Treasury Secretary, Congress intended that taxpayers be permitted to coordinate such treatment using any reasonable method for taking assets into account only once, so long as the method is consistently applied to all controlled foreign corporations (whether or not members of any CFC group) in all taxable years.

9. Treatment of certain leased assets for PFIC purposes (sec. 1703(i)(5) of the Small Business Act, sec. 13231(d)(4) of the 1993 Act, and sec. 1297(d) of the Code)

Prior Law

Under prior and present law, as modified by the 1993 Act, certain property, with respect to which a foreign corporation is the lessee, may be treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the passive foreign investment company ("PFIC") asset test of section 1296(a)(2). The 1993 Act provided a special measurement rule, under which the adjusted basis of the leased asset for this purpose is determined by reference to the unamortized portion of the present value of the payments under the lease for the use of the property. Some have argued, however, that the special measurement rule does not apply to PFICs that are permitted to measure their assets by fair market value, rather than by adjusted basis. Under this argument, the entire fair market value of the leased asset might be treated as owned by the foreign corporation.

Explanation of Provision

The Small Business Act clarifies that in the case of any item of property, with respect to which a foreign corporation is the lessee, and which is treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the PFIC asset test, the amount taken into account with respect to the leased property is the amount determined under the 1993 Act's special measurement rule. This measurement rule is based on the unamortized portion of the present value of the payments under the lease for the use of the property. That is, the provision clarifies that the special measurement rule of the 1993 Act applies to all PFICs, regardless of whether they are generally permitted to measure their assets by fair market value rather than adjusted basis.

10. Expiration date of special ethanol blender refund (sec. 1703(k) of the Small Business Act and sec. 6427 of the Code)

Prior Law

A 54-cents-per-gallon blender income tax credit is provided for ethanol used as a motor fuel. This credit applies to ethanol which is blended with gasoline ("gasohol").

Gasoline is subject to an 18.3-cents-per-gallon excise tax. As an alternative to claiming the income tax credit, gasohol blenders may claim the benefit of the ethanol income tax credit against their gasoline excise tax liability. The benefit may be claimed against excise tax liability in either of two ways: (1) by purchasing gasoline destined for blending with ethanol at a reduced excise tax rate, or (2) before October 1, 1995, by claiming expedited refunds of the excise tax paid on gasoline purchased at the full excise tax rate, after that gasoline is blended with ethanol. In general, the gasoline (including gasohol) excise tax provisions associated with the Highway Trust Fund expire after September 30, 1999.

Explanation of Provision

The Small Business Act corrects a 1990 drafting error by conforming the expiration date for the excise tax expedited refund provision for gasohol blenders to that for gasoline tax provisions generally. Thus, these refunds will be permitted through September 30, 1999.

11. Amortization of goodwill and certain other intangibles (sec. 1703(l) of the Small Business Act, sec. 13261(g) of the 1993 Act and sec. 197 of the Code)

Prior Law

The 1993 Act allows amortization deductions to certain intangible assets acquired after the 1993 Act's effective date that were not amortizable under prior law. The 1993 Act contains "antichurning" rules that deny amortization to intangible assets that were not amortizable under prior law if such assets are acquired by the taxpayer after the effective date from certain related parties.

The 1993 Act also contains an election under which a taxpayer and certain related parties may elect to treat all acquisitions after July 25, 1991 as subject to the provisions of the 1993 Act.

Explanation of Provision

The Small Business Act clarifies that when a taxpayer and its related parties have made an election to apply the 1993 Act to all acquisitions after July 25, 1991, the antichurning rules will not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the antichurning rules in the hands of the acquirer) is transferred to a taxpayer related to the acquirer after the date of enactment of the 1993 Act.

12. Empowerment zones and eligibility of small farms for tax incentives (sec. 1703(m) of the Small Business Act, sec. 13301 of the 1993 Act and sec. 1397B(d)(5)(B) of the Code)

Prior Law

Pursuant to the 1993 Act, on December 21, 1994, six empowerment zones and 65 enterprise communities were designated in eligible urban areas, and three empowerment zones and 30 enterprise communities were designated in rural areas. Special tax incentives (i.e., a wage credit, additional section 179 expensing, and expanded tax-exempt financing) are available for certain business activities conducted in urban and rural empowerment zones. Expanded tax-exempt financing benefits are available for certain facilities located in urban and rural enterprise communities.

The empowerment zone wage credit is not available with respect to any individual employed by a trade or business the principal activity of which is farming (within the meaning of subparagraphs (A) and (B) of section 2032A(e)(5)) if, as of the close of the current taxable year, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of assets of the farm exceed $500,000 (sec. 1396(d)(2)(E)). In contrast, the additional section 179 expensing (available in empowerment zones) and expanded tax-exempt financing benefits (available in both empowerment zones and enterprise communities) are not allowed for any trade or business the principal activity of which is farming if, as of the close of the preceding taxable year, the sum of the aggregate bases (or, if greater, the fair market value) of the assets of the farm exceed $500,000 (sec. 1397B(d)(5)).

Explanation of Provision

The Small Business Act provides that the $500,000 asset test for determining whether a farm is eligible for additional section 179 expensing (in an empowerment zone) and expanded tax-exempt financing benefits (in an empowerment zone or enterprise community) is applied based on the assets of the farm at the end of the current taxable year. Thus, the $500,000 asset test for determining farm eligibility is based on the same taxable period (i.e., the current taxable year) for purposes of all tax incentives available in empowerment zones and enterprise communities.

C. Other Tax Technical Corrections

1. Hedge bonds (sec. 1704(b) of the Small Business Act, sec. 11701 of the 1989 Act, and sec. 149(g) of the Code)

Prior Law

The 1989 Act provided generally that interest on hedge bonds is not tax-exempt unless prescribed minimum percentages of the proceeds are reasonably expected to be spent at set intervals during the five-year period after issuance of the bonds (sec. 149(g)). A hedge bond is defined generally as a bond (1) at least 85 percent of the proceeds of which is not reasonably expected to be spent

within three years following issuance and (2) more than 50 percent of the proceeds of which is invested at substantially guaranteed yields for four years or more.

This restriction does not apply, however, if at least 95 percent of the bond proceeds is invested in other tax-exempt bonds (not subject to the alternative minimum tax). The 95-percent investment requirement is not violated if investment earnings exceeding five percent of the proceeds are temporarily invested for up to 30 days pending reinvestment in taxable (including alternative minimum taxable) investments.

This provision is effective as if included in the Omnibus Budget Reconciliation Act of 1989.

Explanation of Provision

The Small Business Act clarifies that the 30-day exception for temporary investments of investment earnings applies to amounts (i.e., principal and earnings thereon) temporarily invested during the 30-day period immediately preceding redemption of the bonds as well as such periods preceding reinvestment of the proceeds.

2. Withholding on distributions from U.S. real property holding companies (sec. 1704(c) of the Small Business Act, sec. 129 of the Deficit Reduction Act of 1984, and sec. 1445 of the Code)

Prior Law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposition. For this purpose a U.S. real property interest generally includes stock in a domestic corporation that is a U.S. real property holding corporation ("USRPHC"), or was a USRPHC at any time during the previous five years.

A sale or exchange of stock in a USRPHC is an example of a disposition of a U.S. real property interest. In addition, provisions of subchapter C of the Code treat amounts received in certain corporate distributions as amounts received in sales or exchanges, giving rise to tax liability under the FIRPTA rules when a foreign person receives such a distribution from a present or former USRPHC. Thus, amounts received by a foreign shareholder in a USRPHC in a distribution in complete liquidation of the USRPHC are treated as in full payment in exchange for the USRPHC stock, and are therefore subject to tax under FIRPTA (sec. 331; Treas. Reg. sec. 1.897-5T(b)(2)(iii)). Similarly, amounts received by a foreign shareholder in a USRPHC upon redemption of the USRPHC stock are treated as a distribution in part or full payment in exchange for the stock, and are therefore subject to tax under FIRPTA (sec. 302(a); Treas. Reg. sec. 1.897-5T(b)(2)(ii)). Third, amounts received by a foreign shareholder in a USRPHC, in a section 301 distribution from the USRPHC that exceeds the available earnings and profits of the USRPHC, are treated as gain from the sale or exchange of the shareholder's USRPHC stock to the extent that they

exceed the shareholder's adjusted basis in the stock; such amounts are therefore also subject to tax under FIRPTA (sec. 301(c)(3); Treas. Reg. sec. 1.897-5T(b)(2)(i)).

FIRPTA withholding

The Deficit Reduction Act of 1984 established a withholding system to enforce the FIRPTA tax. Unless an exception applies, a transferee of a U.S. real property interest from a foreign person generally is required to withhold the lesser of 10 percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS) (sec. 1445). Such withholding may be reduced or eliminated pursuant to a withholding certificate issued by the Internal Revenue Service (Treas. Reg. sec. 1.1445-3).

Although the FIRPTA withholding requirement by its terms generally applies to all dispositions of U.S. real property interests, and subchapter C treats amounts received in certain distributions as amounts received in sales or exchanges, the FIRPTA withholding provisions also provide express rules for withholding on certain distributions treated as sales or exchanges. Generally, distributions in a transaction to which section 302 (redemptions) or part II of subchapter C (liquidations) applies are subject to 10-percent withholding.[212] Although a section 301 distribution in excess of earnings and profits is also treated as a disposition for purposes of computing the FIRPTA liability of a foreign recipient of the distribution, there is no corresponding withholding provision expressly addressed to the payor of such a distribution.

Explanation of Provision

The Small Business Act clarifies that FIRPTA withholding requirements apply to any section 301 distribution to a foreign person by a domestic corporation that is or was a USRPHC, which distribution is not made out of the corporation's earnings and profits and is therefore treated as an amount received in a sale or exchange of a U.S. real property interest. (The Small Business Act does not alter the withholding treatment of section 301 distributions by such a corporation that are out of earnings and profits.) Under the Small Business Act, the FIRPTA withholding requirements that apply to a section 301 distribution not out of earnings and profits are similar to the requirements applicable to redemption or liquidation distributions to a foreign person by such a corporation. Congress anticipated that withholding certificates will be available to taxpayers that expect to receive section 301 distributions not out of earnings and profits.

The provision is effective for distributions made after the date of enactment of the Small Business Act. No inference is intended to be drawn from the provision as to the FIRPTA withholding requirements applicable to such a distribution under prior law.

[212] Under other rules, dividend distributions (i.e., distributions to which sec. 301(c)(1) applies) to foreign persons by U.S. corporations, including USRPHCs, are subject to 30-percent withholding under the Code. Under treaties, the withholding on a dividend may be reduced to as little as 5 or 15 percent.

3. Treatment of credits attributable to working interests in oil and gas properties (sec. 1704(d) of the Small Business Act, sec. 501 of the Tax Reform Act of 1986, and sec. 469 of the Code)

Prior Law

Under prior and present law, a working interest in an oil and gas property which does not limit the liability of the taxpayer is not a "passive activity" for purposes of the passive loss rules (sec. 469). However, if any loss from an activity is treated as not being a passive loss by reason of being from a working interest, any net income from the activity in subsequent years is not treated as income from a passive activity, notwithstanding that the activity may otherwise have become passive with respect to the taxpayer.

Explanation of Provision

The Small Business Act clarifies that any credit attributable to a working interest in an oil and gas property, in a taxable year in which the activity is no longer treated as not being a passive activity, will not be treated as attributable to a passive activity to the extent of any tax allocable to the net income from the activity for the taxable year. Any credits from the activity in excess of this amount of tax will continue to be treated as arising from a passive activity and will be treated under the rules generally applicable to the passive activity credit. The provision applies to taxable years beginning after December 31, 1986.

4. Clarification of passive loss disposition rule (sec. 1704(e) of the Small Business Act, sec. 501 of the Tax Reform Act of 1986, sec. 1005(a)(2)(A) of the Technical and Miscellaneous Revenue Act of 1988, and sec. 469(g)(1)(A) of the Code)

Prior Law

The Tax Reform Act of 1986 ("1986 Act") provided that if a passive activity is disposed of in a transaction in which all gain or loss is recognized, any overall loss from the activity in the year of disposition is recognized and allowed against income (whether active or passive income).[213] The language of the 1986 Act provided that any loss was allowable, first, against income or gain from the passive activity, second, against income or gain from all passive activities, and finally, against any other income or gain. This rule was rewritten by the technical corrections portion of the Technical and Miscellaneous Revenue Act of 1988 ("1988 Act"). The statutory language (as amended by the 1988 Act) providing for the computation of the overall loss for the taxable year of disposition is not entirely clear where the activity is disposed of at a gain.

Explanation of Provision

The Small Business Act clarifies the rule relating to the computation of the overall loss allowed upon the disposition of a pas-

[213] See S. Rept. 99-313, p. 725.

sive activity. The Small Business Act provides that, in a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the activity for the taxable year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) in excess of any net income or gain from other passive activities for the taxable year is treated as a loss which is not from a passive activity. The provision applies to taxable years beginning after December 31, 1986.

5. Estate tax unified credit allowed nonresident aliens under treaty (sec. 1704(f)(1) of the Small Business Act, sec. 5032(b)(2) of the 1988 Act, and sec. 2102(c)(3)(A) of the Code)

Prior Law

Amount subject to tax

For U.S. citizens and residents, the amount subject to Federal estate and gift tax is determined by reference to all property, wherever situated. For nonresident aliens, the Code provides that the amount subject to Federal estate and gift tax is determined only by reference to property situated in the United States.

The United States has entered into bilateral treaties designed to avoid double transfer taxation. Early treaties typically did this by providing rules for determining situs and requiring that the State of domicile allow a credit for taxes paid to the situs country.[214] In contrast, treaties signed in the 1980s, and the U.S. and OECD model treaties, exempt most property, wherever situated, from taxation outside the State of domicile.[215]

Specific exemption and unified credit

Prior to the Tax Reform Act of 1976 ("1976 Act"), the Code allowed a "specific exemption" against the estate tax. The estate of a U.S. citizen or resident was allowed an exemption of $60,000, while the estate of a nonresident alien was allowed a lesser amount. A number of U.S. estate tax treaties ratified in the 1950s allowed a nonresident alien a "specific exemption" equal to the exemption allowed a U.S. citizen or resident multiplied by the percentage of the gross estate subject to U.S. estate tax (the "pro rata exemption").[216]

The 1976 Act replaced the specific exemption with a unified credit of $47,000 for the estate of U.S. citizen or resident and $3,600 for the estate of a nonresident alien. After 1976, two courts interpreted the pro rata exemption allowed in the 1950s treaties as applying to the unified credit, i.e., as allowing a unified credit no less than the unified credit allowed a U.S. citizen or resident multiplied

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[214] See Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *Explanation of Proposed Estate and Gift Tax Treaty Between the United States and Sweden* 8 (1984).

[215] See, e.g., U.S. Treasury Model Estate and Gift Tax Treaty (1980), Article 7, paragraph 1: "Transfers and deemed transfers by an individual domiciled in a Contracting State of property other an property referred to in Article 5 (Real Property) and 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) shall be taxable only in that State."

[216] See Rev. Rul. 81-303, 1981-2 C.B. 255.

by the percentage of the gross estate situated in the United States (and therefore subject to U.S. estate tax under those treaties).[217]

The 1988 Act increased the unified credit allowed an estate of a nonresident alien to $13,000. In so doing, the 1988 Act provided that, "to the extent required by any treaty," the estate of a nonresident alien is allowed a unified credit equal to the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate situated in the United States (Code sec. 2102(c)(3)(A)). Thus, the 1988 Act did not override the "specific exemption" language of the 1950s treaties, as interpreted by the two courts, and could be interpreted as encouraging the negotiation of pro rata unified credits in future treaties.

Explanation of Provision

The Small Business Act clarifies that in determining the pro rata unified credit required by treaty, property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. Under this rule, a treaty granting a pro rata unified credit would allow a nonresident alien the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate subject to U.S. estate tax, as modified by treaty.

The provision is not intended to affect existing treaties that contain pro rata exemptions pursuant to which the assets reserved for situs taxation by the non-domiciliary country are specifically described. In the case of a treaty that contains a pro rata exemption but does not provide rules for determining the situs for property (e.g., the treaty with Canada), the Small Business Act clarifies that property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. The Senate Foreign Relations Committee Report with respect to the revised protocol amending the tax convention with Canada anticipated the enactment of this provision (Sen. Exec. Rep. No. 104-9, 104th Cong., 1st Sess. at 15). For future treaties, Congress intended that any pro rata unified credit negotiated not exceed the proportion of the gross worldwide estate subject to U.S. estate and gift tax, as modified by treaty.

The provision is effective upon the date of its enactment.

6. Limitation on deduction for certain interest paid by corporation to related persons (sec. 1704(f)(2)(A) of the Small Business Act, sec. 7210(a) of the 1989 Act, and sec. 163(j) of the Code)

Prior Law

Subject to certain limitations, a taxpayer may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The 1989 Act added a so-called "earnings stripping" limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of "disqualified interest" paid or accrued by the corporation during that year. If in a taxable year a deduction is dis-

[217] See *Mudry v. United States,* 11 Cl. Ct. 207 (1986) (Swiss treaty); *Burghardt v. Commissioner,* 80 T.C. 705 (1983), affd., 734 F.2d 3 (3d Cir. 1984) (Italian treaty).

allowed, under the provision, for an amount of interest paid or accrued in that year, the disallowed amount is treated under the earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year.[218]

In order for the earnings stripping provision to apply to a corporation for a taxable year, two thresholds must be exceeded. To exceed the first threshold, the corporation must have "excess interest expense" as that term is defined in the Code for this purpose. To exceed the second threshold, the corporation must have a ratio of debt to equity as of the close of the taxable year in question (or on any other day prescribed by the Treasury Secretary in regulations) that exceeds 1.5 to 1. Excess interest expense is the excess (if any) of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward from a prior year. Excess limitation is the excess (if any) of 50 percent of adjusted taxable income over net interest expense.

Explanation of Provision

The Small Business Act provides that the debt-equity threshold does not apply for purposes of applying the earnings stripping provision to a carryover of excess interest expense from a prior taxable year. Thus, the Small Business Act clarifies that excess interest carried forward from a year in which the debt-equity ratio threshold is exceeded may be deducted in a subsequent year in which that threshold is not exceeded, but only to the extent that such interest would not otherwise be treated as excess interest expense in the carryforward year.

For example, assume that in year 1 $20 of a corporation's interest expense is nondeductible due to the operation of the earnings stripping provision. The corporation carries forward the $20 of interest deduction that it could not use in year 1. Assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and $50 of current net and gross interest expense, all of which is disqualified interest, and that it earns $400 of adjusted taxable income. The provision is intended to clarify that the $20 of interest carried forward from year 1 is deductible in year 2. This is because $70, the sum of the current net interest expense for year 2 ($50) plus the interest expense carried over from year 1 ($20), does not exceed one-half of adjusted taxable income in year 2.

As another example, assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and $50 of current net and gross interest expense, all of which is disqualified interest, and that it earns $80 of adjusted taxable income. The provision is intended to clarify that the $20 of interest carried forward from year 1 is not deductible in year 2. This is because the current net interest expense for year 2 ($50) exceeds by $10 one-half of adjusted taxable income in year 2 ($80 divided by 2, or $40). Therefore, treating the year 1 carryover as an interest expense in year 2 causes the corporation to have excess interest expense equal to $30. But for the debt-eq-

[218] Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. (If, in accordance with a U.S. income tax treaty, interest income of a related person is subject to a reduced rate of U.S. tax, a portion of the interest paid to the related person is deemed to be interest on which no tax is imposed.)

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uity safe harbor, the corporation would have a $30 interest expense disallowance in year 2 if the carried over amount were treated as having been paid in year 2. Under the Small Business Act, no actual year 2 interest can be disallowed. However, under these facts, none of the interest carried over from year 1 can be deducted in year 2. Instead, the interest carried over from year 1 is carried forward for potential deduction (subject to the same rules that applied to the carryforward in year 2) in a year subsequent to year 2.

As a third example, assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and $50 of current net and gross interest expense, all of which is disqualified interest, and that it earns $110 of adjusted taxable income. The provision is intended to clarify that $5 of interest carried forward from year 1 is deductible in year 2, and the other $15 of interest carried forward from year 1 is not deductible in year 2. This is because the current net interest expense for year 2 ($50) is $5 less than one-half of adjusted taxable income in year 2 (one-half of $110, or $55). Therefore, even if the debt-equity safe harbor had not been met in year 2, the corporation would have had $5 of excess limitation in year 2 had there been no carryover amount from year 1. On the other hand, treating the year 1 carryover as an interest expense in year 2 causes the corporation to have excess interest expense equal to $15. This $15 may be carried forward to a subsequent year.

The provision is effective as if included in the amendments made by section 7210(a) of the Revenue Reconciliation Act of 1989.

7. Interaction between passive activity loss rules and earnings stripping rules (sec. 1704(f)(2)(B) and (C) of the Small Business Act, sec. 7210(a) of the 1989 Act, and sec. 163(j) of the Code)

Prior Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. Deductions and credits that are suspended are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. The passive loss rules apply to any taxpayer that is an individual, estate, trust, closely held C corporation, or personal service corporation. In determining passive activity deductions, Treasury regulations provide that "an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211" (Treas. Reg. sec. 1.469-2(d)(8)). Thus, these regulations effectively require other limitations to be applied before applying the passive loss rules.

The at-risk rules limit deductible losses from an activity to the amount that the taxpayer has at risk, in the case of an individual

or a closely-held corporation (sec. 465). The amount at risk is generally the sum of (1) cash contributions, (2) the adjusted basis of contributed property, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security property not used in the activity. The amount at risk is increased by income from the activity and decreased by losses and withdrawals.

A taxpayer generally may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The Revenue Reconciliation Act of 1989 (the "1989 Act") added an "earnings stripping" limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of "disqualified interest" paid or accrued by the corporation during that year. Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. The disallowed amount is treated under the earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year. Proposed Treasury regulations would provide that "sections 465 and 469 shall be applied before applying section 163(j)" (Prop. Treas. Reg. sec. 1.163(j)-7(b)(3)).

Explanation of Provision

The provision modifies section 163(j) of the Code to clarify that the earnings stripping rules apply before the passive loss rules and the at-risk rules.

The provision is effective as if included in the 1989 Act.

8. Branch-level interest tax (sec. 1704(f)(3) of the Small Business Act, sec. 1241 of the 1986 Act, and sec. 884 of the Code)

Prior Law

Interest paid (or treated as if paid) by a U.S. trade or business (i.e., a U.S. branch) of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. The Treasury Department has regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be deducted in arriving at the U.S. branch's effectively connected taxable income.

To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is subject to the 30-percent tax, absent a specific Code exemption or treaty reduction (sec. 884(f)(1)(B)).

These branch-level interest taxes, along with the branch profits tax, were intended to reflect the view that a foreign corporation doing business in the United States generally should be subject to the same substantive tax rules that apply to a foreign corporation operating in the United States through a U.S. subsidiary.[219] Where a U.S. corporation pays interest to its foreign corporate parent, that interest, like the interest deducted by a U.S. branch of a foreign corporation, is also generally subject to a 30-percent U.S. withholding tax unless the tax is reduced by treaty. In the case of a U.S. subsidiary of a foreign parent corporation, the withholding tax applies without regard to whether the interest payment is currently deductible by the U.S. subsidiary. For example, deductions for interest may be delayed or denied under section 163, 263, 263A, 266, 267, or 469, but it is still subject (or not subject) to withholding when paid without regard to the operation of those provisions.

Explanation of Provision

The Small Business Act provides that the branch level interest tax on interest not actually paid by the branch applies to any interest which is allocable to income which is effectively connected with the conduct of a trade or business in the United States. Similarly, in the case of interest paid by the U.S. branch, the Small Business Act provides Treasury regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be allocable to income which is effectively connected with the conduct of a trade or business in the United States. Thus, where an interest expense of a foreign corporation is allocable to U.S. effectively connected income, but that interest expense would not have been fully deductible for tax purposes under another Code provision had it been paid by a U.S. corporation, the Small Business Act clarifies that such interest is nonetheless treated for branch level interest tax purposes like a payment by a U.S. corporation to a foreign corporate parent. Similarly, with regard to the Treasury's regulatory authority to treat an interest payment by a foreign corporation's U.S. branch as though not paid by a U.S. person for source and withholding purposes, the Small Business Act clarifies that the Treasury regulatory authority extends to interest payments in excess of those reasonably expected to be allocable to U.S. effectively connected income of the foreign corporation.

These provisions are effective as if they were made by the Tax Reform Act of 1986.

9. Determination of source in case of sales of inventory property (sec. 1704(f)(4) of the Small Business Act, sec. 211 of the 1986 Act, and sec. 865(b) of the Code)

Prior Law

Prior to the 1986 Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule) (see, e.g., Treas. Reg. sec. 1.861-7, T.D. 6258, 1957-2 C.B. 368). While the 1986 Act

[219] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986,* at 1036 (1987).

generally replaced the place-of-sale rule for sales of personal property with a residence-of-the-seller rule (sec. 865(a)), the Small Business Act did not change the place-of-sale rule for most sales of inventory property (sec. 865(b)).

Before and after the 1986 Act, statutory rules for sourcing income from inventory sales have included those covering income from (1) purchasing inventory property outside the United States (other than within a U.S. possession) and selling it in the United States (sec. 861(a)(6)); (2) purchasing inventory property in the United States and selling it outside the United States (sec. 862(a)(6)); (3) selling outside the United States inventory property which has been produced by the taxpayer in the United States (or selling in the United States inventory property which has been produced by the taxpayer outside the United States) (sec. 863(b)(2)); and (4) purchasing inventory property in a U.S. possession and selling it in the United States (sec. 863(b)(3)). Prior to the 1986 Act, these provisions were not limited in application to income from sales of inventory property, but rather covered sales of personal property generally.

In addition to statutory rules for sourcing items of income from transactions involving inventory property specified in the Code, such as those listed above, the Code both before and after the 1986 Act has contained other sourcing rules that do not make specific reference to property sales, and includes general Treasury regulatory authority to allocate and apportion between U.S. and foreign sources items of gross income, expenses, losses, and deductions other than those specified in sections 861(a) and 862(a) (sec. 863(a)). In carving income from the sale inventory property out of the general residence-of-the-seller rule of section 865, section 865(b) makes reference to the above statutory rules making specific reference to inventory property, but not to the general grant of Treasury regulatory authority in section 863(a).

Explanation of Provision

The Small Business Act modifies the general provision relating to the sourcing of income from the sale of personal property (sec. 865) so that the cross-reference to sourcing rules applicable to inventory property includes a reference to all of section 863, rather than simply to section 863(b). The Small Business Act thus clarifies that, to the extent that the Secretary of the Treasury had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Secretary of the Treasury retains that authority under present law with respect to inventory property.

The Small Business Act is not intended to increase the Treasury Secretary's regulatory authority under section 863(a) beyond the authority that he had under the law in effect prior to the enactment of the 1986 Act. Congress intended that no inference be drawn from this provision either as to the correctness of, or as to the post-1986 Act implications of, any judicial decision interpreting the scope of that pre-1986 Act authority.

The provision is effective as if it were included in the 1986 Act.

10. Repeal of obsolete provisions (sec. 1704(f)(5) of the Small Business Act, sec. 10202 of the Revenue Act of 1987, and secs. 6038(a)(1)(F) and 6038A(b)(4) of the Code)

Prior Law

A U.S. person who controls a foreign corporation must report certain information related to that foreign corporation as may be required by the Treasury Secretary (sec. 6038). Information reporting is also required with respect to certain foreign-owned domestic corporations (sec. 6038A). Included under each of these information reporting provisions is a requirement to report such information as the Treasury Secretary may require for purposes of carrying out the provisions of section 453C. Section 453C, relating to certain indebtedness treated as payment on installment obligations (the so-called "proportional disallowance rule"), was repealed in the Revenue Act of 1987.

Explanation of Provision

The Small Business Act repeals as obsolete the information reporting requirements of sections 6038 and 6038A relating to section 453C. The provision is effective upon the date of its enactment.

11. Health care continuation rules (sec. 1704(g) of the Small Business Act, sec. 7862(c)(5) of the 1989 Act, sec. 4980B(f)(2)(B)(i) of the Code, sec. 602(2)(A) of ERISA, and sec. 2202(2)(A) of the Public Health Service Act)

Prior Law

The 1989 Act amended the health care continuation rules to provide that if a covered employee is entitled to Medicare and within 18 months of such entitlement separates from service or has a reduction in hours, the duration of continuation coverage for the spouse and dependents is 36 months from the date the covered employee became entitled to Medicare. One possible interpretation of the statutory language, however, would permit continuation coverage for up to 54 months. This extension of the coverage period was not intended.

Explanation of Provision

The Small Business Act amends the Code (sec. 4980B), title I of the Employee Retirement Income Security Act (sec. 602), and the Public Health Service Act (sec. 2202(2)(A)) to limit the continuation coverage in such cases to no more than 36 months. The provision is effective for plan years beginning after December 31, 1989.

12. Taxation of excess inclusions of a residual interest in a REMIC for taxpayers subject to alternative minimum tax with net operating losses (sec. 1704(h) of the Small Business Act, sec. 671(a) of the 1986 Act, and sec. 860E(a)(6) of the Code)

Prior Law

Residual interests in a REMIC

A real estate mortgage investment conduit ("REMIC") is an entity that holds real estate mortgages. All interests in a REMIC must be "regular interests" or "residual interests." A regular interest is an interest the terms of which are fixed on the start-up day, which unconditionally entitles the holder to receive a specified principal amount, and which provides that interest amounts are payable based on a fixed rate (or a variable rate to the extent provided in the Treasury regulations). A residual interest is any interest that is so designated and that is not a regular interest in a REMIC.

Generally, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of such REMIC for each day during which he held such interest. The taxable income of any holder of a residual interest in a REMIC (other than a thrift institution) for any taxable year cannot be less than the excess inclusion for the year (sec. 860E). Thus, in general, income from excess inclusions cannot be offset by a net operating loss (or net operating loss carryover) in computing the taxpayer's regular tax.

Alternative minimum tax

Taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a rates of 26 and 28 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. A taxpayer may offset no more than ninety percent of its alternative minimum taxable income with its alternative tax net operating loss carryover.

Because the determination of a taxpayer's alternative minimum taxable income begins with taxable income, a holder of a residual interest in a REMIC may have positive alternative minimum taxable income even where the taxpayer has a net operating loss for the year.

Explanation of Provision

The Small Business Act provides that three rules for determining the alternative minimum taxable income of a taxpayer that is not a thrift institution that holds residual interests in a REMIC.

First, the alternative minimum taxable income of such a taxpayer is computed without regard to the REMIC rule that taxable income cannot be less than the amount of excess inclusions. This provision prevents a taxpayer from having to include in alternative

minimum taxable income preference items for which it received no tax benefit.

Second, the alternative minimum taxable income of such a taxpayer for a taxable year cannot be less than the excess inclusions of the residual interests for that year. In effect, this provision prevents nonrefundable credits from reducing the taxpayer's income tax below an amount equal to what the tentative minimum tax would be if computed only on excess inclusions.

Third, the amount of any alternative minimum tax net operating loss deduction of such a taxpayer is computed without regard to any excess inclusions. This provision insures that the net operating losses will not reduce any income attributable to any excess inclusions. Thus, all such taxpayers subject to the alternative minimum tax will pay a tax on excess inclusions at the alternative minimum tax rate, regardless of whether the taxpayer has a net operating loss.

The provision is effective for all taxable years beginning after December 31, 1986, unless the taxpayer elects to apply the rules of the Small Business Act only to taxable years beginning after the date of enactment.

13. Application of harbor maintenance tax to Alaska and Hawaii ship passengers (sec. 1704(i) of the Small Business Act, sec. 1402(a) of the 1986 Act, and sec. 4462(b) of the Code)

Prior Law

A harbor maintenance excise tax ("harbor tax") of 0.125 percent of value applies generally to commercial cargo (including passenger fares) loaded or unloaded at U.S. ports (sec. 4461). The harbor tax does not apply to commercial cargo (other than crude oil with respect to Alaska) loaded or unloaded in Alaska, Hawaii, and U.S. possessions where such cargo is transported to or from the U.S. mainland (for domestic use) or where such cargo is loaded and unloaded in the same State (Alaska or Hawaii) or possession (sec. 4462(b)).

Explanation of Provision

The Small Business Act clarifies that the harbor tax does not apply to passenger fares where the passengers are transported on U.S. flag vessels operating solely within the State waters of Alaska or Hawaii and adjacent international waters (i.e., leaving and returning to a port in the same State without stopping elsewhere).

The provision applies as if included in the Harbor Maintenance Revenue Act of 1986 (April 1, 1987).

14. Modify effective date provision relating to the Energy Policy Act of 1992 (sec. 1704(j) of the Small Business Act and secs. 53 and 30 of the Code)

Prior Law

The nonconventional fuels production credit (sec. 29) cannot reduce the taxpayer's tax liability to less than the amount of the tentative minimum tax. The credit for prior year minimum tax liabil-

ity (sec. 53) is increased by the amount of the nonconventional fuels credit not allowed for the taxable year solely by reason of the limitation based on the taxpayer's tentative minimum tax.

Explanation of Provision

The Small Business Act corrects a cross reference to section 29(b)(6)(B) contained in section 53(d)(1)(B)(iv), and clarifies that the correction applies to taxable years beginning after December 31, 1990. In addition, section 1702(e)(5) of the Small Business Act clarifies that a correction made in the Energy Policy Act of 1992 to a similar cross reference in section 53(d)(1)(B)(iii) applies to taxable years beginning after December 31, 1990.

The Small Business Act also clarifies the relationship between the basis adjustment rules for the electric vehicle credit (sec. 30(d)(1)) and the alternative minimum tax.

15. Treat qualified football coaches plan as multiemployer pension plan for purposes of the Internal Revenue Code (sec. 1704(k) of the Small Business Act and sec. 1022 of ERISA)

Prior Law

Section 3(37) of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by Public Law 100-202 (Continuing Appropriations for Fiscal Year 1988), provides that, for purposes of Title I of ERISA, a qualified football coaches plan generally is treated as a multiemployer plan and may include a qualified cash or deferred arrangement. Under section 3(37) of ERISA, a qualified football coaches plan is defined as any defined contribution plan established and maintained by an organization described in section 501(c) of the Internal Revenue Code (the "Code"), the membership of which consists entirely of individuals who primarily coach football as full-time employees of 4-year colleges or universities, if the organization was in existence on September 18, 1986. This definition is generally intended to apply to the American Football Coaches Association.

However, section 9343(a) of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) provides that Titles I and IV of ERISA are not applicable in interpreting Title II of ERISA (the Code provisions relating to qualified plans), except to the extent specifically provided in the Code or as determined by the Secretary of the Treasury.

Explanation of Provision

The Small Business Act provides that, for purposes of the Internal Revenue Code, a qualified football coaches plan is treated as a multiemployer collectively bargained plan and may include a qualified cash or deferred arrangement.

The provision is effective for years beginning after December 22, 1987 (the date of enactment of P.L. 100-202).

16. Determination of unrecovered investment in annuity contract (sec. 1704(l) of the Small Business Act and sec. 72(b) and (c) of the Code)

Prior Law

An exclusion from income is provided for amounts received as an annuity under an annuity, endowment, or life insurance contract, as determined under a statutory exclusion ratio (sec. 72(b)). The exclusion ratio is determined as the ratio of (1) the taxpayer's investment in the contract (as of the annuity starting date) to (2) the expected return under the contract (as of such date). In the case of a contract with a refund feature, the amount of a taxpayer's investment in the contract is reduced by the value of the refund feature (sec.72(c)).

This exclusion was modified by the Tax Reform Act of 1986 to limit the excludable amount to the taxpayer's unrecovered investment in the contract, and to provide a deduction for the unrecovered investment in the contract if payments as an annuity under the contract cease by reason of the death of an annuitant. In the case of a contract with a refund feature, the 1986 Act modifications reduce the exclusion ratio so that it is possible that less than the entire investment in the contract can be recovered tax-free.

Explanation of Provision

The Small Business Act modifies the definition of the unrecovered investment in the contract, in the case of a contract with a refund feature, so that the entire investment in the contract can be recovered tax-free.

The provision is effective as if enacted in the Tax Reform Act of 1986.

17. Election by parent to claim unearned income of certain children on parent's return (sec. 1704(m) of the Small Business Act and secs. 1 and 59(j) of the Code)

Prior Law

The net unearned income of a child under 14 years of age is taxed to the child at the parent's statutory rate. Net unearned income means unearned income less the sum of $650 (for 1996) and the greater of: (1) $650 (for 1995) or, (2) if the child itemizes deductions, the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

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

A person claimed as a dependent cannot claim a standard deduction exceeding the greater of $650 (for 1996) or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $650 amount is adjusted for inflation but the $1,000 amount is not.

Explanation of Provision

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

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

18. Treatment of certain veterans' reemployment rights (sec. 1704(n) of the Small Business Act and new sec. 414(u) of the Code)

Prior Law

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), Pub. L. No. 103-353, 38 U.S.C. 4301, ff., which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service.

USERRA generally provides that for a reemployed veteran service in the uniformed services is considered service with the employer for retirement plan benefit accrual purposes, and the employer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

Under the Internal Revenue Code, overall limits are provided on contributions and benefits under certain retirement plans. For example, the maximum amount of elective deferrals that can be made by an individual into a qualified cash or deferred arrangement in any taxable year is limited to $9,500 for 1996 (sec. 402(g)). Annual additions with respect to each participant under a qualified defined

contribution plan generally are limited to the lesser of $30,000 (for 1996) or 25 percent of compensation (sec 415(c)). Annual deferrals with respect to each participant under an eligible deferred compensation plan (sec. 457) generally are limited to the lesser of $7,500 or 33-1/3 percent of includible compensation. There is no provision under present law that permits contributions or deferrals to exceed these and other annual limits in the case of contributions with respect to a reemployed veteran.

Other requirements for which there is no special provision for contributions with respect to a reemployed veteran include the limit on deductible contributions and the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules.

Explanation of Provision

The Small Business Act provides special rules in the case of certain contributions ("make-up contributions") with respect to a reemployed veteran that are required or authorized under USERRA. The Small Business Act applies to contributions made by an employer or employee to an individual account plan or to contributions made by an employee to a defined benefit plan that provides for employee contributions.

Under the Small Business Act, if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contributions are not subject to the generally applicable plan contribution limits (i.e., secs. 402(g), 402(h), 403(b), 408, 415, or 457) or the limit on deductible contributions (i.e., secs. 404(a) or 404(h)) as applied with respect to the year in which the contribution is made. In addition, the make-up contribution is not taken into account in applying the plan contribution or deductible contribution limits to any other contribution made during the year. However, the amount of any make-up contribution could not exceed the aggregate amount of contributions that would have been permitted under the plan contribution and deductible contribution limits for the year to which the contribution relates had the individual continued to be employed by the employer during the period of uniformed service.

Under the Small Business Act, a plan to which a make-up contribution is made on account of a reemployed veteran is not treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules (i.e., secs. 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), or 416) by reason of the making of such contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions are not taken into account either for the year in which they are made or for the year to which they relate.

Under the Small Business Act, a special rule applies in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions is treated as meeting the requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reem-

ployment and has the same length as the lesser of (1) the period of the individual's absence due to uniformed service multiplied by three or (2) five years.

The employer is required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions are treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules as described above.

The Small Business Act clarifies that USERRA does not require (1) any earnings to be credited to an employee with respect to any contribution before such contribution is actually made or (2) any make-up allocation of any forfeiture that occurred during the period of uniformed service.

The Small Business Act also provides that the plan loan, plan qualification, and prohibited transaction rules will not be violated merely because a plan suspends the repayment of a plan loan during a period of uniformed service.

The Small Business Act also defines compensation to be used for purposes of determining make-up contributions and would conform the rules contained in the Code with certain rights of reemployed veterans contained in USERRA pertaining to employee benefit plans.

The provision is effective as of December 12, 1994, the effective date of the benefits-related provisions of USERRA.

19. Reporting of real estate transactions (sec. 1704(o) of the Small Business Act and sec. 6045(e)(3) of the Code)

Prior Law

It is unlawful for any real estate reporting person to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions.

Explanation of Provision

The Small Business Act clarifies that real estate reporting persons may take into account the cost of complying with the reporting requirements of Code section 6045 in establishing charges for their services, so long as a separately listed charge for such costs is not made.

The provision is effective on November 11, 1988 (as if originally enacted as part of the amendment to the Code relating to separate charges).

20. Clarification of denial of deductions for stock redemption expenses (sec. 1704(p) of the Small Business Act and sec. 162(k)(2) of the Code)

Prior Law

Section 162(k), added by the Tax Reform Act of 1986, denies a deduction for any amount paid or incurred by a corporation in con-

nection with the redemption of its stock. An exception is provided for any deduction allowable under section 163 (relating to interest). The Internal Revenue Service has taken the position that costs properly allocable to a borrowing the interest on which is deductible under the exception may not be amortized over the period of the loan, due to section 162(k). Different courts have reached differing conclusions when taxpayers have litigated the question.[220]

Explanation of Provision

The Small Business Act clarifies that amounts properly allocable to indebtedness on which interest is deductible and properly amortized over the term of that indebtedness are not subject to the provision of section 162(k) denying a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock.

In addition, the Small Business Act clarifies that the rules of section 162(k) apply to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in section 465(b)(3)(C) (which applies a more than 10 percent relationship test in certain cases).

Thus, for example, the Small Business Act clarifies that the denial of a deduction applies to any reacquisition (i.e., any transaction that is in effect an acquisition of previously outstanding stock) regardless of whether the transaction is treated as a redemption for purposes of subchapter C of the Code, regardless of whether it is treated for tax purposes as a sale of the stock or as a dividend, and regardless of whether the transaction is a reorganization or other transaction.

Apart from the clarification relating to amounts properly allocable to indebtedness, Congress did not intend that application of the 1986 Act deduction denial to any amount or transaction be limited under the Small Business Act.

The provision clarifying that amounts properly allocable to indebtedness and amortized over the term of that indebtedness are not subject to the denial under section 162(k), is effective as if included in the Tax Reform Act of 1986.

The other clarifications apply to amounts paid or incurred after September 13, 1995. No inference is intended that any amounts described in these other clarifications are deductible under present law.

21. Definition of passive income in determining passive foreign investment company status (sec. 1704(r) of the Small Business Act, sec. 1235 of the 1986 Act and sec. 1296(b)(2) of the Code)

Prior Law

Under the export trade corporation (ETC) provisions, a controlled foreign corporation (CFC) that qualifies as an ETC is not subject to current U.S. tax on certain export trade income. In 1971, the ETC provisions were replaced by rules applicable to domestic inter-

[220] See, e.g., *Fort Howard Corp. v. Commissioner,* 103 T.C. 345 (1994) upholding the IRS position; compare *U.S. v. Kroy (Europe) Limited,* 27 F.3d 367 (9th Cir. 1994)(to the contrary).

national sales corporations (DISCs). Only those ETCs in existence at that time are allowed to continue operating as ETCs. In 1984, the DISC provisions were largely replaced by the rules applicable to foreign sales corporations (FSCs). Certain foreign trade income of a FSC is exempt from U.S. income tax. In addition, a domestic corporation is allowed a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income.

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs). A foreign corporation is a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average amount of its assets consists of assets that produce, or are held for the production of passive income. Passive income for this purpose generally means income that satisfies the definition of foreign personal holding company income under subpart F. Foreign personal holding company income generally includes interest, dividends, and annuities; certain rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property. In determining whether a foreign corporation is a PFIC, passive income does not include certain active-business banking, insurance, or (in the case of the U.S. shareholders of a CFC) securities income, or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income).

Explanation of Provision

The Small Business Act clarifies that foreign trade income of a FSC and export trade income of an ETC do not constitute passive income for purposes of the PFIC definition.

The provision is effective as if it were included in the1986 Act.

22. Intermediate sanctions penalty provisions (sec. 1704(s) of the Small Business Act, sec. 1314 of TBOR 2, and sec. 6652(c) of the Code)

Prior Law

Prior and present law imposes monetary penalties on certain tax-exempt organizations for failure to allow public inspection of the organization's annual return and of its application for recognition of tax-exempt status.

Explanation of Provision

The Small Business Act corrects a drafting error in TBOR 2 with respect to the additional filing and disclosure rules imposed on certain tax-exempt organizations as part of the intermediate sanctions provisions. The Small Business Act increases (from $10 to $20 per each day of failure) present-law penalties that apply when a tax-exempt organization fails to allow public inspection of its annual returns (sec. 6652(c)(1)(C)) or fails to allow public inspection of its application for recognition of tax-exempt status (sec. 6652(c)(1)(D)). In addition, the Small Business Act increases the section

6652(c)(1)(C)) maximum penalty with respect to any one return from $5,000 to $10,000.

23. Exclusion from income for combat zone compensation (sec. 1704(t)(4) of the Small Business Act and sec. 112 of the Code)

Prior Law

The Code provides that gross income does not include compensation received by a taxpayer for active service in the Armed Forces of the United States for any month during any part of which the taxpayer served in a combat zone (or was hospitalized as a result of injuries, wounds or disease incurred while serving in a combat zone) (limited to $500 per month for commissioned officers). The heading refers to "combat pay," although that term is no longer used to refer to special pay provisions for members of the Armed Forces, nor is the exclusion limited to those special pay provisions (hazardous duty pay (37 U.S.C. sec. 301) and hostile fire or imminent danger pay (37 U.S.C. sec. 310)).

Explanation of Provision

The Small Business Act modifies the heading of Code section 112 to refer to "combat zone compensation" instead of "combat pay." The Small Business Act also makes conforming changes to cross-references elsewhere in the Code. This provision is effective on the date of enactment.

PART FIVE:

REVENUE PROVISIONS OF THE HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (H.R. 3103)[221]

I. TAX-RELATED HEALTH PROVISIONS

A. Medical Savings Accounts (sec. 301 of HIPA and new secs. 220 and 4980E of the Code)

Present and Prior Law

Under present and prior law, the tax treatment of health expenses depends on whether the individual is an employee or self employed, and whether the individual is covered under an employer-sponsored health plan. Employer contributions to a health plan for coverage for the employee and the employee's spouse and dependents is excludable from the employee's income and wages for social security tax purposes. Under prior law, self-employed individuals were entitled to deduct 30 percent of the amount paid for health insurance for the self-employed individual and his or her spouse or dependents. This 30-percent deduction is gradually increased to 80 percent under section 311 of the Health Insurance Portability and Accountability Act of 1996 ("HIPA"). Any individual who itemizes tax deductions may deduct unreimbursed medical expenses (including expenses for medical insurance) paid during the year to the extent that the total of such expenses exceeds 7.5 percent of the individual's adjusted gross income ("AGI"). Prior law did not contain any special rules for medical savings accounts.

Reasons for Change

The fact that Americans with low-deductible health insurance have few incentives to lower their health costs or benefit from staying well is a major factor affecting health care cost growth. One approach to providing incentives for Americans to be more cost conscious purchasers of medical services is to make available alternatives to low-deductible insurance such as medical savings accounts ("MSAs"). MSAs will give people more control over their health care dollars. Because MSAs afford people the opportunity to save unspent MSA funds for future health and long-term care

[221] Public Law 104-191; signed on August 21, 1996.

H.R. 3103 was reported by the House Committee on Ways and Means on March 25, 1996 (H. Rept. 104-496, Pt. 1), and was passed by the House on March 28, 1996. The Senate version was S. 1028, which was reported by the Senate Committee on Labor and Human Resources on October 12, 1995 (S. Rept. 104-156). H. R. 3103, as amended, was passed by the Senate on April 23, 1996. The conference report was filed on July 31, 1996 (H. Rept. 104-736), and was approved by the House on August 1,1996 and by the Senate on August 2, 1996.

needs, the Congress believed that people will be more prudent in their purchase of health care services.

Explanation of Provision

In general

Within limits, contributions to an MSA are deductible in determining AGI if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.[222]

Eligible individuals

Beginning in 1997, MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals regardless of the size of the entity for which the individual performs services.[223] For example, suppose P is a partner in a partnership PS, a professional partnership which has 100 partners and 300 employees. P is covered under the partnership's plan, which is a high deductible plan, and no other health plan. P is eligible to contribute to an MSA.

An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. In determining whether an employer is a small employer, a preceding year is not taken into account unless the employer was in existence throughout such year. In the case of an employer that was not in existence throughout the first preceding year, the determination of whether the employer has no more than 50 employees is based on the average number of employees that the employer reasonably expects to employ on business days in the current year. In determining the number of employees of an employer, controlled groups of corporations (sec. 414(b)), unincorporated trades or businesses under common control (sec. 414(c)), affiliated service groups (sec. 414(m)), and certain businesses as provided in regulations (sec. 414(o)) are treated as a single employer.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage, described below). In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer. However, an individual is not eligible to make contributions to an

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[222] HIPA (sec. 193) amends the Public Health Service Act to provide that health maintenance organizations may offer high deductible plans (as defined under the new Code provisions relating to MSAs). Thus, providing they are otherwise eligible, an individual with a high deductible plan through an HMO is eligible for an MSA.

[223] Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

MSA for a year if any employer contributions are made to an MSA on behalf of the individual for the year. Similarly, if the individual's spouse is covered under the high deductible plan covering such individual and the spouse's employer makes a contribution to an MSA for the spouse, the individual may not make MSA contributions for the year. For example, suppose individual A works for a small employer and is covered under a high deductible plan that covers A and her spouse, B. A's employer makes a contribution for a year to an MSA for A. B is not entitled to make contributions to an MSA for that year.

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage, described below). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse). For example, suppose individual A is an employee of business X. A also has a business which generates self-employment income. Because A's high deductible plan coverage is provided by an employer, A is not eligible to have an MSA by reason of being self-employed. However, A would nevertheless be eligible for an MSA if X is a small employer (and A is not covered under another plan, other than a plan providing permitted coverage).

An individual with other coverage in addition to a high deductible plan is still eligible for an MSA if such other coverage is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Permitted insurance is: (1) Medicare supplemental insurance; (2) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (3) insurance for a specified disease or illness; and (4) insurance that provides a fixed payment for hospitalization.

Individuals covered under Medicare are not eligible for an MSA. Medicare coverage is not a high deductible plan and Medicare is not permitted coverage. For example, if an individual is covered under a high deductible plan and also under Medicare (e.g., the individual is still employed and Medicare is secondary payor), the individual is not eligible for an MSA because the individual has coverage that is not permitted coverage in addition to the high deductible plan.

If a small employer with an MSA plan (i.e., the employer or its employees made contributions to an MSA) ceases to become a small employer (i.e., exceeds the 50-employee limit), then the employer (and its employees) can continue to establish and make contributions to MSAs (including contributions for new employees and employees that did not previously have an MSA) until the year following the first year in which the employer has more than 200 employees. After that, those employees who had an MSA (to which indi-

vidual or employer contributions were made in any year) can continue to make contributions (or have contributions made on their behalf) even if the employer has more than 200 employees. For example, suppose Employer A has 48 employees in 1995, 105 employees in 1996, 105 employees in 1997, and 205 employees in 1998. A would be a small employer in 1997 because it has 50 or fewer employees in the preceding or the second preceding year. Employer A would still be considered a small employer in 1998 because it had been a small employer, and also had fewer than 200 employees in prior years. However, in years after 1998, Employer A would not be considered a small employer (even if the number of employees fell to 50 or below), and in years after 1999, the only employees of Employer A who can make new MSA contributions (or have employer contributions made on their behalf) are those employees who had MSA contributions in conjunction with a high deductible plan with Employer A prior to 1999.

Tax treatment of and limits on contributions

Individual contributions to an MSA are deductible (within limits) in determining AGI (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. No deduction is allowed to any individual for MSA contributions if such individual is a dependent on another taxpayer's tax return.

In the case of a self-employed individual, the deduction cannot exceed the individual's earned income from the trade or business with respect to which the high deductible plan is established. In the case of an employee, the deduction cannot exceed the individual's compensation attributable to the employer sponsoring the high deductible plan in which the individual is enrolled.

The maximum annual contribution that can be made to an MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage. No other dollar limits on the maximum contribution apply. The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month.

Contributions for a year can be made until the due date for the individual's tax return for the year (determined without regard to extensions).

In order to facilitate application of the cap on the number of MSA participants, described below, the employer is required to report employer MSA contributions, and the individual is required to report such employer MSA contributions on the individual's tax return.

Comparability rule for employer contributions

If an employer provides high deductible health plan coverage coupled with an MSA to employees and makes employer contributions to the MSAs during a calendar year, the employer must make available a comparable contribution on behalf of all employees with

comparable coverage during the same coverage period in the calendar year. Contributions are considered comparable if they are either of the same dollar amount or the same percentage of the deductible under the high deductible plan. If an employee is employed for only a portion of the calendar year, a contribution to the MSA of such employee is treated as comparable if it is an amount which bears the same ratio to the comparable contribution as the portion of the year he or she is employed bears to the calendar year. The comparability rule is applied separately to part-time employees (i.e., employees who are customarily employed for fewer than 30 hours per week). No restrictions are placed on the ability of the employer to offer different plans to different groups of employees. The comparability rule does not restrict contributions that can be made to an MSA by a self-employed individual.

For example, suppose an employer maintains two high deductible plans, Plan A, with a deductible of $1,500 for individual coverage and $3,000 for family coverage, and Plan B, with a deductible of $2,000 for individual coverage and $4,000 for family coverage. The employer offers an MSA contribution to full-time employees in Plan A of $500 for individual coverage and $750 for family coverage. In order to satisfy the comparability rule, the employer would have to offer full-time employees covered under Plan B one of the following MSA contributions: (1) $500 for employees with individual coverage and $750 for employees with family coverage or (2) $667 for employees with individual coverage and $1,000 for employees with family coverage. Different contributions (or no contributions) could be made for part-time employees covered under either high deductible plan.

If employer contributions do not comply with the comparability rule during a calendar year, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to MSAs of the employer for the year. The excise tax is designed as a proxy for the denial of employer contributions. In the case of a failure to comply with the comparability rule which is due to reasonable cause and not to willful neglect, the Secretary may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved.

For purposes of the comparability rule, employers under common control are aggregated in the same manner as in determining whether the employer is a small employer. The comparability rule does not fail to be satisfied in a year if the employer is precluded from making contributions for all employees with high deductible plan coverage because the employer has more than 200 employees or due to operation of the cap during the initial 4-year period.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,500 and no more than $2,250 in the case of individual coverage and at least $3,000 and no more than $4,500 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,000 in the case of individual coverage and no more than $5,500 in the case of family coverage. Beginning after 1998, the dollar amounts are indexed for inflation in $50 dollar in-

crements based on the consumer price index. A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

As under present law, State insurance commissions would have oversight over the issuance of high deductible plans issued in conjunction with MSAs and could impose additional consumer protections. It is intended that the National Association of Insurance Commissioners ("NAIC") will develop model standards for high deductible plans that individual States could adopt.

Tax treatment of MSAs

Earnings on amounts in an MSA are not currently includible in income.

Taxation of distributions

Distributions from an MSA for the medical expenses of the individual and his or her spouse or dependents are generally are excludable from income.[224] However, in any year for which a contribution is made to an MSA, withdrawals from an MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible plan for the month in which the expenses were incurred.[225] This rule is designed to ensure that MSAs are in fact used in conjunction with a high deductible plan, and that they are not primarily used by other individuals who have health plans that are not high deductible plans.

For example, suppose that, in 1997, individual A is covered by a high deductible plan, and A's spouse ("B") is covered by a health plan that is not a high deductible plan. A makes contributions to an MSA for 1997. Withdrawals from the MSA to pay B's medical expenses incurred in 1997 would be includible in income (and subject to the additional tax on nonmedical withdrawals) because B is not covered by a high deductible plan.

For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

The MSA trustee or custodian is responsible for reporting the amount of distributions in a year from an MSA. However, the MSA trustee or custodian is not responsible for determining whether or

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[224] This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

[225] The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even if for an individual who is not an eligible individual.

not a distribution is excludable from income or subject to the additional 15-percent tax (e.g., the trustee or custodian is not responsible for monitoring expenses or use of MSA funds). The account holder is responsible for properly reporting distributions as taxable or nontaxable on his or her tax return (and whether or not the additional 15-percent tax applies). The account holder is responsible for supporting a claim that distributions are not taxable (e.g., through maintenance of proper records of medical expenses), just as individuals are responsible for supporting deductions, e.g., the itemized deduction for medical expenses.[226]

Estate tax treatment

Upon death, any balance remaining in the decedent's MSA is includible in his or her gross estate.

If the account holder's surviving spouse is the named beneficiary of the MSA, then, after the death of the account holder, the MSA becomes the MSA of the surviving spouse and the amount of the MSA balance may be deducted in computing the decedent's taxable estate, pursuant to the estate tax marital deduction provided in Code section 2056. The MSA qualifies for the marital deduction because the account holder has sole control over disposition of the assets in the MSA. The surviving spouse is not required to include any amount in income as a result of the death; the general rules applicable to MSAs apply to the surviving spouse's MSA (e.g., the surviving spouse is subject to income tax only on distributions from the MSA for nonmedical purposes). The surviving spouse can exclude from income amounts withdrawn from the MSA for expenses incurred by the decedent prior to death, to the extent they otherwise are qualified medical expenses.

If, upon death, the MSA passes to a named beneficiary other than the decedent's surviving spouse, the MSA ceases to be an MSA as of the date of the decedent's death, and the beneficiary is required to include the fair market value of MSA assets as of the date of death in gross income for the taxable year that includes the date of death. The amount includible in income is reduced by the amount in the MSA used, within one year of the death, to pay qualified medical expenses incurred prior to the death. As is the case with other MSA distributions, whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred. In computing taxable income, the beneficiary may claim a deduction for that portion of the Federal estate tax on the decedent's estate that was attributable to the amount of the MSA balance (calculated in accordance with the present-law rules relating to income in respect of a decedent set forth in sec. 691(c)).

If there is no named beneficiary for the decedent's MSA, the MSA ceases to be an MSA as of the date of death, and the fair market value of the assets in the MSA as of such date are includible in the decedent's gross income for the year of the death. This rule applies in all cases in which there is no named beneficiary, even if the surviving spouse ultimately obtains the right to MSA assets (e.g., if the surviving spouse is the sole beneficiary of the decedent's

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[226] Similarly, although the MSA trustee or custodian is responsible for reporting the amount of MSA contributions, the trustee or custodian is not responsible for determining whether the contributions are in fact deductible.

estate). Because of the significant tax consequences if a married individual fails to name his or her spouse as the MSA beneficiary, even if the rights to MSA assets are otherwise acquired by the surviving spouse, it is anticipated that the marketing materials describing other tax aspects of MSAs will explain the consequences of failure to name the spouse as the beneficiary.

Cap on taxpayers utilizing MSAs

In general

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the 4-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants) or (2) are employed by a participating employer, would be eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.[227] However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer.

In a year after a cut-off year, employees of a participating employer can establish new MSAs and make new contributions (even if the employee is a new employee or did not previously have an MSA). An employer is a participating employer if (1) the employer made any MSA contributions on behalf of employees in the cut-off year or any preceding year or (2) at least 20 percent of the employees covered under a high deductible plan made an MSA contribution of at least $100 in the cut-off year.

In the case of a cut-off year before 2000, an individual is not an eligible individual or an active MSA participant unless the individual was first covered under a high deductible plan on or before the cut-off date. The cut-off date is generally October 1 of the cut-off year. However, if the individual was enrolled in an employer-sponsored plan pursuant to a regularly scheduled enrollment period that occurs during the last 3 months of the year, then the cut-off date is December 31. Similarly, an employer is not considered a participating employer if it first offered coverage after October 1 of a cut-off year unless the high deductible plan is offered pursuant to a regularly scheduled enrollment period. In addition, a self-employed individual is not considered an eligible individual or an active MSA participant unless the individual was covered under a high deductible plan on or before November 1 of a cut-off year.

[227] Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

These rules are designed to prevent high deductible plans from being first offered just before the limitation on MSAs is effective in order to avoid application of the cap. They are not, however, intended to preclude individuals who first enroll in an employer-sponsored high deductible health plan or employees of employers that adopt a high deductible plan in a cut-off year due to normal health plan operation from having MSAs. For example, suppose a small employer offers a high deductible plan that provides that new employees may be covered under the plan beginning the first day of the month after the month in which they are hired. New employee A (whose previous coverage was not high deductible coverage) is hired on October 15, and is enrolled in the high deductible plan November 1 of that year. If the year is a cut-off year, Employee A is an eligible individual and, if he has an MSA contribution for the year, an active participant for the year because he was enrolled pursuant to a regularly scheduled enrollment period. Similarly, suppose that employer A is a small employer and does not currently offer health care coverage. In 1997, A decides to offer health plan coverage to its employees, including a high deductible plan coupled with an MSA. A takes steps to provide such coverage on or before October 1 of the year (e.g., making arrangements with insurance companies or distributing plan material to employees). The first enrollment period for the health plans begins September 1, and coverage under the plan will begin November 1. If the year is a cut-off year, the employer is a participating employer because the plan was established pursuant to a regularly scheduled enrollment period.

Under certain circumstances, MSA participation may be reopened after a cut-off year so that MSAs are again available to all individuals in the qualifying group of self-employed individuals and employees of small employers.

For the 1997 tax year, taxpayers are permitted to establish MSAs provided that they are in the qualifying group of self-employed individuals or employees working for small employers.

Rules for 1997

On or before June 1, 1997, each trustee or custodian of an MSA (e.g., insurance company or financial institution) is required to report to the IRS the total number of MSAs established on or before April 30, 1997, for which it acts as trustee or custodian, including the number of MSAs established for previously uninsured individuals.[228] If, based on this reporting, the number of MSAs established (but excluding those established for previously uninsured individuals) as of April 30, 1997, exceeds 375,000 (50 percent of 750,000), on or before September 1, 1997, the IRS would publish guidance providing that only active MSA participants or employees of participating employers would be eligible for an MSA contribution for the 1998 tax year and thereafter. If this threshold is exceeded, an individual who is first covered by an employer-sponsored high deductible health plan after September 1, 1997, is not

[228] This report is to include the name and social security number of taxpayers establishing an MSA. Failures to report are subject to a penalty of $25 for each MSA up to a maximum of $5,000. A trustee or custodian required to report could elect to do so on a company-wide or branch-by-branch basis.

an eligible individual or an active MSA participant (and therefore cannot have an MSA for 1997 or a subsequent year) unless the high deductible coverage is elected pursuant to a regularly scheduled enrollment period occurring during the last 4 months of the year. Similarly, an employer is not considered a participating employer if it first offered a high deductible plan after September 1, 1997, unless the plan was offered pursuant to a regularly scheduled enrollment period. Also, a self-employed individual would not be an eligible individual or an active MSA participant unless the individual was first covered under a high deductible plan on or before October 1, 1997.

If the 375,000 cap is not exceeded, then another determination of MSA participation will be made, as follows. On or before August 1, 1997, each trustee or custodian of an MSA is required to report to the IRS the total number of MSAs established on or before June 30, 1997, for which it acts as trustee or custodian, including the number of MSAs established for previously uninsured individuals. If, based on this reporting, the number of MSAs established (but excluding those established for previously uninsured individuals) exceeds the 1997 threshold level of 525,000 (70 percent of 750,000), on or before October 1, 1997, the IRS would publish guidance providing that only active MSA participants or employees of participating employers would be eligible for an MSA contribution for the 1998 tax year and thereafter. If this threshold is exceeded, an individual who is first covered by an employer-sponsored high deductible health plan after October 1, 1997, is not an eligible individual or an active MSA participant (and therefore cannot have an MSA for 1997 or a subsequent year) unless the high deductible coverage is elected pursuant to a regularly scheduled enrollment period occurring during the last 3 months of the year. Similarly, an employer is not considered a participating employer if it first offered a high deductible plan after October 1, 1997, unless the plan was offered pursuant to a regularly scheduled enrollment period. Also, a self-employed individual would not be an eligible individual or an active MSA participant unless the individual was first covered under a high deductible plan on or before November 1, 1997.

If the 1997 threshold level is not exceeded, all taxpayers in the qualifying eligible group (i.e., self-employed individuals and employees working for employers with 50 or fewer employees) would be permitted to have MSA contributions for the 1998 tax year.

Rules for 1998 and succeeding years

In general.—In 1998 and succeeding years, on or before August 1 of the year, each trustee or custodian of an MSA is required to report to the IRS the total number of MSAs established on or before June 30 for the current year,[229] including the number of such MSAs established for previously uninsured individuals. In addition, the IRS is directed to collect data with respect to the number of taxpayers showing an MSA contribution on their individual income tax returns for the prior year and the extent to which such tax-

[229] That is, the report would not include MSAs to which contributions are made for the prior year.

payers were previously uninsured.[230] If, based on this information, the IRS determines as described below that the number of taxpayers anticipated to have MSA contributions (disregarding previously uninsured individuals) exceeds the applicable threshold level, the IRS is required to issue guidance to the public by no later than October 1. If this guidance is issued, then only taxpayers who are active MSA participants or who are employed by a participating employer would be entitled to MSA contributions in tax years following the year the guidance is issued.

For 1998 and succeeding years, the threshold is exceeded if either of the following limits are exceeded. The numerical limit is exceeded if either: (1) the number of MSA returns filed on or before April 1 of the year, plus the estimate of the number of MSA returns for such year that will be filed after such date exceeds the applicable threshold; or (2) 90 percent of the amount determined under (1), plus 15/6ths of the MSAs established for the year before July 1 exceeds 750,000.

1998.—In 1998, the IRS would analyze the return data from the filing of 1997 tax year returns and would determine, based on this data, the number of taxpayers with MSA contributions for 1997 and who were not previously uninsured. If the IRS determines that (1) MSA returns filed on or before April 15, 1998, plus the estimated number of MSA return for 1997 filed after such date exceeds 600,000, or (2) that 90 percent of the MSA returns in (1), plus 15/6ths of the number of MSAs established for 1998 between January 1 and July 1, 1998, the IRS would publish guidance on or before October 1, 1998, advising taxpayers that only taxpayers who had previously had MSA contributions (i.e., for either the 1997 or 1998 tax year) or who are employed by a participating employer would be eligible for MSA contributions in succeeding tax years. If the 1998 threshold is exceeded, an individual who is first covered by an employer-sponsored high deductible health plan after October 1, 1998, is not an eligible individual or an active MSA participant (and therefore cannot have an MSA for 1998 or a subsequent year) unless the high deductible coverage is elected pursuant to a regularly scheduled enrollment period occurring during the last 3 months of the year. Similarly, an employer is not considered a participating employer if it first offered a high deductible plan after October 1, 1998, unless the plan was offered pursuant to a regularly scheduled enrollment period. Also, a self-employed individual would not be an eligible individual or an active MSA participant unless the individual was first covered under a high deductible plan on or before November 1, 1998.

In the event that the threshold level had not been exceeded, all taxpayers in the qualifying eligible group would be permitted to establish MSAs during the 1999 tax year.

1999.—In 1999, the IRS would analyze the return data from the filing of 1998 tax year returns and would determine, based on this data, the number of taxpayers with MSA contributions for 1998 and who were not previously uninsured. If the IRS determines that (1) MSA returns filed on or before April 15, 1999, plus the esti-

[230] Each income tax return on which an MSA contribution is shown is treated as one taxpayer for purposes of the cap. It is anticipated that the IRS would adjust the actual return information to take into account MSAs that may have been established by late filers.

mated number of MSA returns for 1998 filed after such date, or (2) 90 percent of the MSA returns in (1), plus 15/6ths of the number of MSAs established for 1998 between January 1 and July 1, 1999, exceeds 750,000, the IRS would publish guidance on or before October 1, 1999, advising taxpayers that only taxpayers who had previously had MSA contributions (i.e., for the 1997, 1998, or 1999 tax year) or who are employed by a participating employer would be eligible for MSA contributions in succeeding tax years. If the 1999 threshold is exceeded, an individual who is first covered by an employer-sponsored high deductible health plan after October 1, 1999, is not an eligible individual or an active MSA participant (and therefore cannot have an MSA for 1999 or a subsequent year) unless the high deductible coverage is elected pursuant to a regularly scheduled enrollment period occurring during the last 3 months of the year. Similarly, an employer is not considered a participating employer if it first offered a high deductible plan after October 1, 1999, unless the plan was offered pursuant to a regularly scheduled enrollment period. Also, a self-employed individual would not be an eligible individual or an active MSA participant unless the individual was first covered under a high deductible plan on or before November 1, 1999.

In the event that the threshold level had not been exceeded, all taxpayers in the qualifying eligible group would be permitted to establish MSAs during the 2000 tax year.

Reopening of MSA participation.—If 1997 is a cut-off year, then in 1998, the IRS would (as described above) analyze the return data from the filing of 1997 tax year returns and would determine, based on this data, the number of taxpayers with MSA contributions for 1997 and who were not previously uninsured. If the IRS determines that MSA returns filed on or before April 15, 1998, plus the estimated number of MSA returns for 1997 filed after such date (disregarding MSAs of previously uninsured individuals) exceeds 750,000, then the IRS will announce by October 1, 1998, that MSAs will be available to all eligible individuals in the qualifying eligible group of self-employed individuals and employees of small employers covered under a high deductible health plan during the first 6 months of 1999. Similarly, if 1998, is a cut-off year, then in 1999, if MSA returns filed on or before April 15, 1999, plus the estimated number of MSA returns for 1998 filed after such date (disregarding MSAs of previously uninsured individuals) exceeds 750,000, then the IRS will announce by October 1, 1998, that MSAs will be available to all eligible individuals in the qualifying eligible group of self-employed individuals and employees of small employers with high deductible plan coverage during the first 6 months of 2000.

End of pilot project

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees or (2) at least 20 percent of the employees cov-

ered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

Measuring the effects of MSAs

During 1997-2000, the Department of the Treasury will evaluate MSA participation and the reduction in Federal revenues due to such participation and make such reports of such evaluations to the Congress as the Secretary determines appropriate.

The General Accounting Office is directed to contract with an organization with expertise in health economics, health insurance markets and actuarial science to conduct a study regarding the effects of MSAs in the small group market on (1) selection (including adverse selection), (2) health costs, including the impact on premiums of individuals with comprehensive coverage, (3) use of preventive care, (4) consumer choice, (5) the scope of coverage of high deductible plans purchased in conjunction with an MSA and (6) other relevant issues, to be submitted to the Congress by January 1, 1999.

It is intended that the study be broad in scope, gather sufficient data to fully evaluate the relevant issues, and be adequately funded. It is expected that the study will utilize appropriate techniques to measure the impact of MSAs on the broader health care market, including in-depth analysis of local markets with high penetration. It is expected that the study will evaluate the impact of MSAs on individuals and families experience high health care costs, especially low- and middle-income families.

Definition of MSA

In general, an MSA is a trust or custodial account created exclusively for the benefit of the account holder and is subject to rules similar to those applicable to individual retirement arrangements.[231] The trustee of a MSA can be a bank, insurance company,[232] or other person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with applicable requirements.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $118 million in 1997, $249 million in 1998, $264 million

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[231] For example, MSA contributions (other than amounts rolled over from another MSA) must be in cash, no MSA assets can be invested in life insurance contracts, MSA assets cannot be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in a MSA must be nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to a MSA or pledges assets in a MSA, rules similar to those for IRAs apply, and any amounts treated as distributed to the account holder under those rules are treated as not used for qualified medical expenses.

[232] The acquisition expenses of an insurance company relating to the establishment of a MSA would not be subject to the rules relating to the capitalization of policy acquisition expenses.

in 1999, $285 million in 2000, $303 million in 2001, $320 million in 2002, $338 million in 2003, $356 million in 2004, $373 million in 2005, and $391 million in 2006.

B. Increase in Deduction for Health Insurance Expenses of Self-Employed Individuals (sec. 311 of HIPA and sec. 162(l) of the Code)

Present and Prior Law

Under prior law, self-employed individuals were entitled to deduct 30 percent of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents.[233] Under present and prior law, the deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction is available in the case of self insurance as well as commercial insurance. The self-insured plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Under present and prior law, employees can exclude from income 100 percent of employee-provided health insurance.

Reasons for Change

The Congress believed it appropriate to increase the deduction for health insurance expenses of self-employed individuals in order to reduce the disparity of treatment of such expenses and employer-provided health insurance and to help make health insurance more affordable for self-employed individuals.

Explanation of Provision

HIPA increases the deduction for health insurance of self-employed individuals as follows: the deduction is 40 percent in 1997; 45 percent in 1998 through 2002; 50 percent in 2003; 60 percent in 2004; 70 percent in 2005; and 80 percent in 2006 and thereafter.

HIPA also provides that payments for personal injury or sickness through an arrangement having the effect of accident or health insurance (and that is not merely a reimbursement arrangement) are excludable from income. In order for the exclusion to apply, the arrangement must be insurance (e.g., there must be adequate risk shifting). This provision equalizes the treatment of payments under commercial insurance and arrangements other than commercial insurance that have the effect of insurance. Under this provision, a self-employed individual who receives payments from such an arrangement can exclude the payments from income.

Effective Date

The provision is effective for taxable years beginning after December 31, 1996. No inference is intended with respect to the ex-

[233] See discussion of Public Law 104-7 in Part One of this pamphlet for the 1995 increase in the deduction to 30 percent.

cludability of payments under arrangements having the effect of accident or health insurance under prior law.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $64 million in 1997, $238 million in 1998, $340 million in 1999, $377 million in 2000, $410 million in 2001, $445 million in 2002, $537 million in 2003, $824 million in 2004, $1,290 million in 2005, and $1,827 million in 2006.

C. Treatment of Long-Term Care Insurance and Services (secs. 321-327 of HIPA and secs. 106, 125, 213, 4980B, 4980C, 6050Q, and 7702B of the Code)

Present and Prior Law

In general

Prior law generally did not provide explicit rules relating to the tax treatment of long-term care insurance contracts or long-term care services. Thus, the treatment of long-term care contracts and services was unclear. Prior and present law do provide rules relating to medical expenses and accident or health insurance.

Itemized deduction for medical expenses

In determining taxable income for Federal income tax purposes, a taxpayer is allowed an itemized deduction for unreimbursed expenses that are paid by the taxpayer during the taxable year for medical care of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer, to the extent that such expenses exceed 7.5 percent of the adjusted gross income of the taxpayer for such year (sec. 213). For this purpose, expenses paid for medical care generally are defined as amounts paid: (1) for the diagnosis, cure, mitigation, treatment, or prevention of disease (including prescription medicines or drugs and insulin), or for the purpose of affecting any structure or function of the body (other than cosmetic surgery not related to disease, deformity, or accident); (2) for transportation primarily for, and essential to, medical care referred to in (1); or (3) for insurance (including Part B Medicare premiums) covering medical care referred to in (1) and (2).

Exclusion for amounts received under accident or health insurance

Amounts received by a taxpayer under accident or health insurance for personal injuries or sickness generally are excluded from gross income to the extent that the amounts received are not attributable to medical expenses that were allowed as a deduction for a prior taxable year (sec. 104).

Treatment of accident or health plans maintained by employers

Contributions of an employer to an accident or health plan that provides compensation (through insurance or otherwise) to an employee for personal injuries or sickness of the employee, the employee's spouse, or a dependent of the employee, are excluded from

the gross income of the employee (sec. 106). In addition, amounts received by an employee under such a plan generally are excluded from gross income to the extent that the amounts received are paid, directly or indirectly, to reimburse the employee for expenses for the medical care of the employee, the employee's spouse, or a dependent of the employee (sec. 105). For this purpose, expenses incurred for medical care are defined in the same manner as under the rules regarding the deduction for medical expenses.

A cafeteria plan is an employer-sponsored arrangement under which employees can elect among cash and certain employer-provided qualified benefits. No amount is included in the gross income of a participant in a cafeteria plan merely because the participant has the opportunity to make such an election (sec. 125). Employer-provided accident or health coverage is one of the benefits that may be offered under a cafeteria plan.

A flexible spending arrangement (FSA) is an arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care, and under which the maximum amount of reimbursement that is reasonably available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. Under proposed Treasury regulations, a maximum amount of reimbursement is not substantially in excess of the total premium if such maximum amount is less than 500 percent of the premium. An FSA may be part of a cafeteria plan or provided by an employer outside a cafeteria plan. FSAs are commonly used to reimburse employees for medical expenses not covered by insurance. If certain requirements are satisfied,[234] amounts reimbursed for nontaxable benefits from an FSA are excludable from income.

Health care continuation rules

The health care continuation rules require that an employer must provide qualified beneficiaries the opportunity to continue to participate for a specified period in the employer's health plan after the occurrence of certain events (such as termination of employment) that would have terminated such participation (sec. 4980B). Individuals electing continuation coverage can be required to pay for such coverage.

Reasons for Change

The long-term care rules of HIPA provide an incentive for individuals to take financial responsibility for their long-term care needs. HIPA therefore generally provides favorable tax treatment with respect to long-term care insurance contracts and services meeting HIPA's requirements.

[234] These requirements include a requirement that a health FSA can only provide reimbursement for medical expenses (as defined in sec. 213) and cannot provide reimbursement for premium payments for other health coverage and that the maximum amount of reimbursement under a health FSA must be available at all times during the period of coverage.

Explanation of Provision

Tax treatment and definition of long-term care insurance contracts and qualified long-term care services

Exclusion of long-term care proceeds

A long-term care insurance contract generally is treated as an accident and health insurance contract. Amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract generally are excludable as amounts received for personal injuries and sickness, subject to a cap of $175 per day, or $63,875 annually, as indexed, on per diem contracts only. The dollar cap is indexed by the medical care cost component of the consumer price index.

Employer-provided long-term care coverage

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan. Employer-provided coverage under a long-term care insurance contract is not, however, excludable by an employee if provided through a cafeteria plan; similarly, expenses for long-term care services cannot be reimbursed under an FSA.[235] Thus, employer contributions (other than through a cafeteria plan) for long-term care insurance for the employee, his or her spouse, and his or her dependents (as defined for tax purposes) are excludable from income and wages for employment tax purposes. Employer contributions for long-term care insurance are deductible by the employer. Amounts received from long-term care insurance purchased by the employer are excludable from income in accordance with the rules relating to excludability of proceeds of accident or health insurance (and subject to the cap on per diem contracts).

Definition of long-term care insurance contract

A long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements are that (1) the contract is guaranteed renewable, (2) the contract does not provide for a cash surrender value or other money that can be paid, assigned, pledged or borrowed, (3) refunds (other than refunds on the death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits, and (4) the contract generally does not pay or reimburse expenses reimbursable under Medicare (except where Medicare is a secondary payor, or the contract makes per diem or other periodic payments without regard to expenses).

A contract does not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses incurred during the period.

[235] HIPA does not otherwise modify the requirements relating to FSAs. An FSA is defined as a benefit program providing employees with coverage under which specified incurred expenses may be reimbursed (subject to maximums and other reasonable conditions), and the maximum amount of reimbursement that is reasonably available to a participant is less than 500 percent of the value of the coverage.

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State-maintained plans

Under HIPA, an arrangement is treated as a qualified long-term care insurance contract if an individual receives coverage for qualified long-term care services under a State long-term care plan, and the terms of the arrangement would satisfy the requirements for a long-term care insurance contract under the provision, were the arrangement an insurance contract. For this purpose, a State long-term care plan is any plan established and maintained by a State (or instrumentality of such State) under which only employees (and former employees, including retirees) of a State or of a political subdivision or instrumentality of the State, and their relatives, and their spouses and spouses' relatives, may receive coverage only for qualified long-term care services. "Relative" is defined as under section 152(a)(1)-(8). No inference was intended with respect to the tax consequences of such arrangements under prior law.

Medicare duplication rules

HIPA provides that no provision of law shall be construed or applied so as to prohibit the offering of a long-term care insurance contract on the basis that the contract coordinates its benefits with those provided under Medicare. Thus, long-term care insurance contracts are not subject to the rules requiring duplication of Medicare benefits.

Definition of qualified long-term care services

Qualified long-term care services means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner. Maintenance and personal care services may include meal preparation, household cleaning, and other similar services which the chronically ill individual is unable to perform. It is anticipated that the scope of maintenance and personal care services will be defined in Treasury regulations.

A chronically ill individual is one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days[236] due to a loss of functional capacity, (2) having a similar level of disability as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services, or (3) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Activities of daily living are eating, toileting, transferring, bathing, dressing and continence.[237]

[236] The 90-day period is not a waiting period. Thus, for example, an individual can be certified as chronically ill if the licensed health care practitioner certifies that the individual will be unable to perform at least 2 activities of daily living for at least 90 days. The certification of an insured as a chronically ill individual may occur at any time, and is intended to take into account the sum of continuous prior days when the insured was chronically ill and future days when the insured is expected to remain chronically ill.

[237] HIPA provides that, for purposes of determining whether an individual is chronically ill, the number of activities of daily living that are taken into account under the contract may not be less than five. For example, a contract could require that an individual be unable to perform

It was intended that an individual who is physically able but has a cognitive impairment such as Alzheimer's disease or another form of irreversible loss of mental capacity be treated similarly to an individual who is unable to perform (without substantial assistance) at least 2 activities of daily living. Because of the concern that eligibility for the medical expense deduction not be diagnosis-driven, the provision requires the cognitive impairment to be severe. It was intended that severe cognitive impairment mean a deterioration or loss in intellectual capacity that is measured by clinical evidence and standardized tests which reliably measure impairment in: (1) short- or long-term memory; (2) orientation to people, places or time; and (3) deductive or abstract reasoning. In addition, it was intended that such deterioration or loss place the individual in jeopardy of harming self or others and therefore require substantial supervision by another individual.

A licensed health care practitioner is a physician (as defined in sec. 1861(r)(1) of the Social Security Act) and any registered professional nurse, licensed social worker, or other individual who meets such requirements as may be prescribed by the Secretary of the Treasury. A licensed social worker includes any social worker who has been issued a license, certificate, or similar authorization to act as a social worker by a State or a body authorized by a State to issue such authorizations.

Expenses for long-term care services treated as medical expenses

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). For this purpose, amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expenses actually incurred for medical care.

For purposes of the deduction for medical expenses, qualified long-term care services do not include services provided to an individual by a relative or spouse (directly, or through a partnership, corporation, or other entity), unless the relative is a licensed professional with respect to such services, or by a related corporation (within the meaning of Code section 267(b) or 707(b)).[238]

(without substantial assistance) two out of any five of the activities listed in HIPA. By contrast, a contract does not meet this requirement if it required that an individual be unable to perform two out of any four of the activities listed in HIPA. This requirement does not apply to the determination of whether an individual is a chronically ill individual either (1) by virtue of severe cognitive impairment, or (2) if the insured satisfies a standard (if any) that is not based upon activities of daily living, as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

[238] The rule limiting such services provided by a relative or a related corporation does not apply for purposes of the exclusion for amounts received under a long-term care insurance contract, whether the contract is employer-provided or purchased by an individual. The limitation is unnecessary in such cases because it is anticipated that the insurer will monitor reimbursements to limit opportunities for fraud in connection with the performance of services by the taxpayer's relative or a related corporation.

Long-term care insurance premiums treated as medical expenses

Long-term care insurance premiums that do not exceed specified dollar limits are treated as medical expenses for purposes of the itemized deduction for medical expenses.[239] The limits are as follows:

In the case of an individual with an attained age before the close of the taxable year of:	*The limitation on premiums paid for such taxable years is:*
Not more than 40	$200
More than 40 but not more than 50	375
More than 50 but not more than 60	750
More than 60 but not more than 70	2,000
More than 70	2,500

For taxable years beginning after 1997, these dollar limits are indexed for increases in the medical care component of the consumer price index. The Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, is directed to develop a more appropriate index to be applied in lieu of the foregoing. Such an alternative might appropriately be based on increases in skilled nursing facility and home health care costs. It is intended that the Treasury Secretary annually publish the indexed amount of the limits as early in the year as they can be calculated.

Deduction for long-term care insurance of self-employed individuals

The present-law 30 percent deduction for health insurance expenses of self-employed individuals is phased up to 80 percent under HIPA. Because HIPA treats payments of eligible long-term care insurance premiums in the same manner as medical insurance premiums, the self-employed health insurance deduction applies to eligible long-term care insurance premiums under HIPA.

The deduction for health insurance expenses of a self-employed individual is not available for a month for which the individual is eligible to participate in any subsidized health plan maintained by any employer of the individual or the individual's spouse. The fact that an individual is eligible for employer-subsidized health insurance is not intended to affect the ability of such an individual to deduct long-term care insurance premiums, so long as the individual is not eligible for employer-subsidized long-term care insurance.[240]

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the por-

[239] Similarly, within certain limits, in the case of a rider to a life insurance contract, charges against the life insurance contract's cash surrender value that are includible in income are treated as medical expenses (provided the rider constitutes a long-term care insurance contract).

[240] A technical correction may be necessary so that the statute reflects this intent.

tion of the contract providing such coverage were a separate contract. The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value. The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). In addition, it is anticipated that Treasury regulations will provide for appropriate reduction in premiums paid (within the meaning of sec. 7702(f)(1)) to reflect the payment of benefits under the rider that reduce the cash surrender value of the life insurance contract. A similar rule should apply in the case of a contract governed by section 101(f) and in the case of the payments under a rider that are excludable under section 101(g) of the Code (as added by HIPA).

Health care continuation rules

The health care continuation rules do not apply to coverage under a long-term care insurance contract. The health care continuation rules do not apply to coverage under a plan, substantially all of the coverage under which is for qualified long-term care services.

Inclusion of excess long-term care benefits

HIPA provides for the following calculation of the dollar cap applicable to aggregate payments under per diem type long-term care insurance contracts and amounts received with respect to a chronically ill individual pursuant to a life insurance contract.[241] The amount of the dollar cap with respect to any one chronically ill individual (who is not terminally ill) is $175 per day ($63,875 annually, as indexed), reduced by the amount of reimbursements and payments received by anyone for the cost of qualified long-term care services for the chronically ill individual. If more than one payee receives payments with respect to any one chronically ill individual, then everyone receiving periodic payments with respect to the same insured is treated as one person for purposes of the dollar cap. The amount of the dollar cap is utilized first by the chronically ill person, and any remaining amount is allocated in accordance with Treasury regulations. If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of actual costs (in excess of the dollar cap) incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to rules relating to return of basis under Code section 72.

[241] See item D, below, relating to "Treatment of Accelerated Death Benefits Under Life Insurance Contracts."

A grandfather rule is provided under HIPA in the case of a per diem type contract issued to a policyholder on or before July 31, 1996. Under the grandfather rule, the amount of the dollar cap with respect to such a per diem contract is calculated without any reduction for reimbursements for qualified long-term care services under any other contract issued with respect to the same insured on or before July 31, 1996. The other provisions of the dollar cap are not affected by the grandfather rule. The grandfather rule ceases to apply as of the time that any of the contracts issued on or before July 31, 1996, with respect to the insured are exchanged, or benefits are increased.

Congress wished to clarify that, although the legislation imposes a daily (or equivalent) dollar cap on the amount of excludable benefits under certain types of long-term care insurance in certain circumstances, this limitation is not intended to suggest a preference or otherwise convey or facilitate a competitive advantage to one type of long-term care insurance compared to another type of long-term care insurance.

The Chairmen of the House Committee on Ways and Means and the Senate Finance Committee are directed jointly to request that the NAIC, in consultation with representatives of the insurance industry and consumer organizations, develop and conduct a study to determine the marketing and other effects, if any, of the dollar limit on excludable long-term care benefits under certain types of long-term care insurance contracts under the bill. Such Chairmen are to request that the NAIC, if it agrees to such request, shall submit the results of its study to the such Committees by no later than two years after agreeing to the request.

The $175 per day limit is indexed for inflation after 1997 for increases in the medical care component of the consumer price index. The Treasury Secretary, in consultation with the Secretary of Health and Human Services, is directed to develop a more appropriate index, to be applied in lieu of the foregoing. Such an alternative might appropriately be based on increases in skilled nursing facility and home health care costs. It is intended that the Treasury Secretary annually publish the indexed amount of the limit as early in the year as it can be calculated.

A payor of long-term care benefits (defined for this purpose to include any amount paid under a product advertised, marketed or offered as long-term care insurance) is required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. In addition, a payor is required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition such amounts are paid, and whether the contract under which the amount is paid is a per diem-type contract. A copy of the report must be provided to the payee by January 31 following the year of payment, showing the name of the payor and the aggregate amount of benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee is subject to the generally applicable penalties for failure to file similar information reports.

Life insurance company reserves

In determining reserves for insurance company tax purposes, HIPA provides that the Federal income tax reserve method applicable for a long-term care insurance contract issued after December 31, 1996, is the method prescribed by the NAIC (or, if no reserve method has been so prescribed, a method consistent with the tax reserve method for life insurance, annuity or noncancellable accident and health insurance contracts, whichever is most appropriate). The method currently prescribed by the NAIC for long-term care insurance contracts is the one-year full preliminary term method. As under prior and present law, however, in no event may the tax reserve for a contract as of any time exceed the amount which would be taken into account with respect to the contract as of such time in determining statutory reserves.

Consumer protection provisions

Under HIPA, long-term care insurance contracts, and issuers of contracts, are required to satisfy certain provisions of the long-term care insurance model Act and model regulations promulgated by theNAIC (as adopted as of January 1993).

The contract requirements relate to disclosure, nonforfeitability, guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, post-claims underwriting, minimum standards, inflation protection, preexisting conditions, and prior hospitalization. HIPA also provides disclosure and nonforfeiture requirements. The nonforfeiture provision gives consumers the option of selecting reduced paid-up insurance, extended term insurance, or a shortened benefit period in the event a policyholder who elects a nonforfeiture provision is unable to continue to pay premiums.[242] The requirement that insurers offer policyholders a nonforfeiture benefit does not preclude the imposition of a reasonable delay period. The consumer protection provisions that apply with respect to the terms of the contract apply only for purposes of determining whether a contract is a qualified long-term care insurance contract (within the meaning of HIPA).

The requirements for issuers of long-term care insurance contracts relate to application forms, reporting requirements, marketing, appropriateness of purchase, format, delivering a shopper's guide, right to return, outline of coverage, group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period. A tax is imposed equal to $100 per insured per day for failure to satisfy these requirements. The consumer protection requirements for issuers of contracts apply with respect to contracts that are qualified long-term care insurance contracts (within the meaning of HIPA).

[242] The nonforfeiture provision shall provide for a benefit available in the event of a default in the payment of any premiums and the amount of the benefit may be adjusted subsequent to being initially granted only as necessary to reflect changes in claims, persistency, and interest as reflected in changes in rates for premium paying policies approved by the appropriate State regulatory authority for the same contract form. A technical correction may be necessary so that the statute reflects this intent.

HIPA provides that, for purposes of both the requirements as to contract terms and the requirements relating to issuers of contracts, the determination of whether any requirement of a model regulation or model Act has been met is made by the Secretary of the Treasury. It was not intended that the Secretary create a Federal standard, but rather, look to applicable or appropriate State standards or to those provided specifically in the model regulation or model Act.

HIPA provides that an otherwise qualified long-term care insurance contract will not fail to be a qualified long-term care insurance contract, and will not be treated as failing to meet the analogous requirement under HIPA, solely because it satisfies a consumer protection standard imposed under applicable State law that is more stringent than the analogous standard provided in HIPA. HIPA does not preclude States from enacting more stringent consumer protection provisions than the analogous standards under HIPA.

Effective Date

The provisions defining long-term care insurance contracts and qualified long-term care services apply to contracts issued after December 31, 1996. Any contract issued before January 1, 1997, that met the long-term care insurance requirements of the State in which the contract was sitused at the time it was issued is treated as a qualified long-term care insurance contract, and services provided under or reimbursed by the contract are treated as qualified long-term care services. Solely for purposes of this grandfather rule, and not for other purposes, it is intended that in the case of a group contract that was issued before January 1, 1997, the contract will not cease to be treated as issued before January 1, 1997, solely by reason of the addition after December 31, 1996, of individuals to the coverage (as of December 31, 1996) under the contract. It is intended that a contract be treated as meeting the long-term care insurance requirements of the State, if it meets the insurance requirements of the State with respect to insurance contracts covering types of long-term care services (such as only nursing home care, or only home health care), even though such State requirements are separate from long-term care insurance requirements, or prohibit the contract from being labeled a long-term care contract. Similarly, a State waiver of a long-term care insurance requirement (such as the loss ratio requirement) in the case of a long-term care rider or provision under a life insurance contract is not intended to cause the contract to be treated as not meeting the long-term care insurance requirements of the State.

A contract providing for long-term care insurance may be exchanged for a long-term care insurance contract (or the former canceled and the proceeds reinvested in the latter within 60 days) tax free between the date of enactment and January 1, 1998. Taxable gain would be recognized to the extent money or other property is received in the exchange.

The issuance or conformance of a rider to a life insurance contract providing long-term care insurance coverage is not treated as a modification or a material change for purposes of applying sections 101(f), 7702 and 7702A of the Code.

The provisions relating to treatment of eligible long-term care premiums and long-term care services as a medical expense generally are effective for taxable years beginning after December 31, 1996.

The provisions relating to the maximum exclusion for certain long-term care benefits and reporting are effective for taxable years beginning after December 31, 1996. Thus, the initial year in which reports will be filed with the IRS and copies provided to the payee will be 1998, with respect to long-term care benefits paid in 1997.

The provision relating to life insurance company reserves is effective for contracts issued after December 31, 1997.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $108 million in 1997, $667 million in 1998, $645 million in 1999, $663 million in 2000, $743 million in 2001, $827 million in 2002, $905 million in 2003, $1,009 million in 2004, $1,103 million in 2005, and $1,205 million in 2006.

D. Treatment of Accelerated Death Benefits Under Life Insurance Contracts (secs. 331-332 of HIPA and secs. 101(g), 818(g), 6050Q, and 7702B of the Code)

Present and Prior Law

Treatment of amounts received under a life insurance contract

If a contract meets the definition of a life insurance contract, gross income does not include insurance proceeds that are paid pursuant to the contract by reason of the death of the insured (sec. 101(a)). In addition, the undistributed investment income ("inside buildup") earned on premiums credited under the contract is not subject to current taxation to the owner of the contract. The exclusion under section 101 applies regardless of whether the death benefits are paid as a lump sum or otherwise.

Under prior law, amounts received under a life insurance contract (other than a modified endowment contract) prior to the death of the insured were includible in the gross income of the recipient to the extent that the amount received constitutes cash value in excess of the taxpayer's investment in the contract. Generally, the investment in the contract is the aggregate amount of premiums paid less amounts previously received that were excluded from gross income.

If a contract fails to be treated as a life insurance contract under section 7702(a), inside buildup on the contract is generally subject to tax (sec. 7702(g)).

Requirements for a life insurance contract

To qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement (sec. 7702(a)). A contract satisfies the cash value accu-

mulation test if the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium and cash value corridor tests if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and if the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract.

Proposed regulations on accelerated death benefits

The Treasury Department issued proposed regulations[243] under which certain "qualified accelerated death benefits" paid by reason of the terminal illness of an insured would have been treated as paid by reason of the death of the insured and therefore qualify for exclusion under section 101. In addition, the proposed regulations would have permitted an insurance contract that includes a qualified accelerated death benefit rider to qualify as a life insurance contract under section 7702. Thus, the proposed regulations would have provided that including this benefit would not cause an insurance contract to fail to meet the definition of a life insurance contract.

Under the proposed regulations, a benefit would have qualified as a qualified accelerated death benefit only if it met three requirements. First, the accelerated death benefit could be payable only if the insured becomes terminally ill. Second, the amount of the benefit had to equal or exceed the present value of the reduction in the death benefit otherwise payable.[244] Third, the cash surrender value and the death benefit payable under the policy had to be reduced proportionately as a result of the accelerated death benefit.

For purposes of the proposed regulations, an insured would have been treated as terminally ill if he or she had an illness that, despite appropriate medical care, the insurer reasonably expected to result in death within twelve months from the payment of the accelerated death benefit. The proposed regulations would not have applied to viatical settlements.

Reasons for Change

Congress wished to extend the present-law rule permitting an exclusion from income for amounts paid under a life insurance contract by reason of the death of the insured to accelerated death benefits paid with respect to certain terminally ill and chronically ill insured individuals. In addition, Congress believed that this exclusion from income should be extended to certain sales or assignments of all or a portion of a life insurance contract to a viatical settlement provider. Congress believed that a single set of rules should apply to benefits received with respect to a chronically ill individual to the extent possible. To provide parity in treatment,

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[243] Prop. Treas. Reg. Secs. 1.101-8, 1.7702-0, 1.7702-2, and 1.7702A-1 (December 15, 1992).

[244] For purposes of determining the present value under the proposed regulations, the maximum permissible discount rate would be the greater of (1) the applicable Federal rate that applies under the discounting rules for property and casualty insurance loss reserves, and (2) the interest rate applicable to policy loans under the contract. Also, the present value would be determined assuming that the death benefit would have been paid twelve months after payment of the accelerated death benefit.

the same definition of a chronically ill individual applies for purposes of the rules under this provision and the rules governing long-term care insurance contracts. Further, the $175 per day ($63,875 annual) limit on excludability of benefits under per diem type long-term care insurance contracts applies for chronically ill individuals.

Explanation of Provision

HIPA provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amounts received for the sale or assignment of any portion of the death benefit under a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill.[245] For example, the sale or assignment to a viatical settlement provider of a life insurance contract that has a long-term care insurance rider (payments under which are funded by and reduce the death benefit) is considered the sale or assignment of the death benefit. Sale or assignment of a stand-alone rider providing for long-term care insurance (where payments under the rider are not funded by reductions in the death benefit), however, is not considered the sale or assignment of the death benefit.

The provision does not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer or employee of the taxpayer, or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

A terminally ill individual is defined as one who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification. A physician is defined for this purpose in the same manner as under the long-term care insurance rules of HIPA.[246] An individual who meets the definition of a terminally ill individual is not treated as chronically ill, for purposes of this provision.

A chronically ill individual is defined under the long-term care provisions of HIPA.[247] HIPA clarifies the rules for chronically ill insureds so that the tax treatment of payments with respect to

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[245] If the amount is received under a rider or other provision of the contract that is treated as a long-term care insurance contract under section 7702B (as added by HIPA), the rules of section 7702B apply.

[246] A physician is defined for these purposes as in section 1861(r)(1) of the Social Security Act, which provides that a physician means a doctor of medicine or osteopathy legally authorized to practice medicine and surgery by the State in which he performs such function or action (including a physician within the meaning of section 1101(a)(7) of that Act). Section 1101(a)(7) of that Act provides that the term physician includes osteopathic practitioners within the scope of their practice as defined by State law.

[247] Thus, a chronically ill individual is one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity, (2) having a similar level of disability as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services, or (3) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Activities of daily living are eating, toileting, transferring, bathing, dressing and continence. The number of activities of daily living that are taken into account for this purpose may not be less than five.

chronically ill individuals is reasonably similar under the long-term care rules of HIPA and under this provision. In the case of a chronically ill individual, the exclusion under this provision with respect to amounts paid under a life insurance contract and amounts paid in a sale or assignment to a viatical settlement provider applies if the payment received is for costs incurred by the payee (not compensated by insurance or otherwise) for qualified long-term care services (as defined under the long-term care rules) for the insured person for the period, and two other requirements (similar to requirements applicable to long-term care insurance contracts) are met. The first requirement is that under the terms of the contract giving rise to the payment, the payment is not a payment or reimbursement of expenses reimbursable under Medicare (except where Medicare is a secondary payor under the arrangement, or the arrangement provides for per diem or other periodic payments without regard to expenses for qualified long-term care services). HIPA provides that no provision of law shall be construed or applied so as to prohibit the offering of such a contract giving rise to such a payment on the basis that the contract coordinates its payments with those provided under Medicare. The second requirement is that the arrangement complies with those consumer protection provisions applicable to long-term care insurance contracts and issuers that are specified in Treasury regulations. It was intended that such guidance incorporate rules similar to those of section 6F (relating to right to return, permitting the payee 30 days to rescind the arrangement) of the NAIC Long-Term Care Insurance Model Act, and section 13 (relating to requirements for application, requiring that the payee be asked if he or she already has long-term care insurance, Medicaid, or similar coverage) of the NAIC Long-Term Care Insurance Model Regulations. If the NAIC or the State in which the policyholder resides issues standards relating to chronically ill individuals, then the analogous requirements under Treasury regulations cease to apply.

Payments made on a per diem or other periodic basis, without regard to expenses incurred for qualified long-term care services, are nevertheless excludable under this provision, subject to the $175 per day ($63,875 annually, as indexed) dollar cap on excludable benefits that applies for amounts that are excludable under per diem type long-term care insurance contracts. HIPA provides as follows with respect to the calculation of the dollar cap applicable to aggregate payments under per diem type long-term care insurance contracts and amounts received with respect to a chronically ill individual pursuant to a life insurance contract. The amount of the dollar cap with respect to the aggregate amount received under per diem type long-term care insurance contracts and this provision with respect to any one chronically ill individual (who is not terminally ill) is $175 per day ($63,875 annually), as indexed, reduced by the amount of reimbursements and payments received by anyone for the cost of qualified long-term care services for the chronically ill individual. If more than one payee receives payments with respect to any one chronically ill individual, the amount of the dollar cap is utilized first by the chronically ill person, and any remaining amount is allocated in accordance with Treasury regulations. If payments under such contracts exceed the

dollar cap, then the excess is excludable only to the extent of actual costs incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs (in excess of the dollar cap) were incurred for long-term care services, are fully includable in income without regard to rules relating to return of basis under Code section 72.

The payor of a payment with respect to an individual who is chronically ill is required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. In addition, the payor is required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition such amounts are paid, and whether the contract under which the amount is paid is a per diem-type contract. A copy of the report must be provided to the payee by January 31 following the year of payment, showing the name of the payer and the aggregate amount of such benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee is subject to the generally applicable penalties for failure to file similar information reports.

HIPA provides that a viatical settlement provider is any person regularly engaged in the trade or business of purchasing or taking assignments of life insurance contracts on the lives of insured individuals who are terminally ill or chronically ill, so long as the viatical settlement provider meets certain requirements. The viatical settlement provider must either (1) be licensed, in the State where the insured resides, to engage in such transactions with terminally ill individuals (if the insured is terminally ill) or with chronically ill individuals (if the insured is chronically ill), or (2) if such licensing with respect to the insured individual is not required in the State, meet other requirements depending on whether the insured is terminally or chronically ill. If the insured is terminally ill, the viatical settlement provider must meet the requirements of sections 8 and 9 of the Viatical Settlements Model Act, relating to disclosure and general rules (issued by the NAIC, and also meet the section of the NAIC Viatical Settlements Model Regulation relating to standards for evaluation of reasonable payments, including discount rates, in determining amounts paid by the viatical settlement provider. If the insured is chronically ill, the viatical settlement provider must meet requirements similar to those of sections 8 and 9 of the NAIC Viatical Settlements Model Act, and also must meet the standards, if any, promulgated by the NAIC for evaluating the reasonableness of amounts paid in viatical settlement transactions with chronically ill individuals.

For life insurance company tax purposes, HIPA provides that a life insurance contract is treated as including a reference to a qualified accelerated death benefit rider to a life insurance contract (except in the case of any rider that is treated as a long-term care insurance contract under section 7702B, as added by HIPA). A qualified accelerated death benefit rider is any rider on a life insurance contract that provides only for payments of a type that are excludable under this provision.

Effective Date

The provision applies to amounts received after December 31, 1996. The provision treating a qualified accelerated death benefit rider as life insurance for life insurance company tax purposes takes effect on January 1, 1997. The issuance of a qualified accelerated death benefit rider to a life insurance contract, or the addition of any provision required to conform an accelerated death benefit rider to these provisions, is not treated as a modification or material change of the contract (and is not intended to affect the issue date of any contract under section 101(f)).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $10 million in 1997, $107 million in 1998, $166 million in 1999, $214 million in 2000, $265 million in 2001, $316 million in 2002, $376 million in 2003, $446 million in 2004, $527 million in 2005, and $599 million in 2006.

E. Exemption From Income Tax for State-Sponsored Organizations Providing Health Coverage for High-Risk Individuals; Exemption from Income Tax for State-Sponsored Workers' Compensation Reinsurance Organizations (secs. 341-342 of HIPA and secs. 501(c)(26) and (27) of the Code)

Present and Prior Law

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organizations or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. However, the IRS may be reluctant to rule that particular State risk-pooling entities satisfy the section 501(c)(4) or 115 requirements for tax-exempt status.

Reasons for Change

Congress believed that eliminating the uncertainty concerning the eligibility of certain State health insurance risk pools for tax-exempt status will assist States in providing medical care coverage for their uninsured high-risk residents.

Explanation of Provisions

Health coverage for high-risk individuals

HIPA provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied.[248] The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

HIPA further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

HIPA provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

Effective Date

Health coverage for high-risk individuals

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

[248] No inference is intended as to the tax treatment of other types of State-sponsored organizations.

Workers' compensation reinsurance organizations

The provision applies to taxable years ending after the date of enactment.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $1 million in 1997 and less than $500,000 in 1998, increase such receipts by $4 million in 1999, and reduce such receipts by $2 million in each of 2000 through 2006.

F. Health Insurance Organizations Eligible for Benefits of Section 833 (sec. 351 of HIPA and sec. 833 of the Code)

Present and Prior Law

Under present and prior law, an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (sec. 501(m)). Special rules apply to certain eligible health insurance organizations. Eligible health insurance organizations are (1) Blue Cross and Blue Shield organizations existing on August 16, 1986, which have not experienced a material change in structure or operations since that date, and (2) other organizations that meet certain community-service related requirements and substantially all of whose activities involve the providing of health insurance. Section 833 provides that eligible organizations are generally treated as stock property and casualty insurance companies.

Section 833 provides a special deduction for eligible organizations, equal to 25 percent of the claims and expenses incurred during the year, less the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, and other items attributable to health expenses. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

In addition, section 833 eliminates, for eligible organizations, the 20 percent reduction in unearned premium reserves that applies generally to all property and casualty insurance companies.

Reasons for Change

The Congress believed that fairness dictates that the special rules benefitting Blue Cross and Blue Shield organizations under section 833 also apply to certain organizations that became taxable by reason of the same provision of the Tax Reform Act of 1986 that made Blue Cross and Blue Shield organizations taxable, if such organizations were not Blue Cross or Blue Shield organizations, but otherwise met the eligibility requirements.

Explanation of Provision

HIPA applies the special rules under section 833 to the same extent they are provided to certain existing Blue Cross or Blue Shield organizations, in the case of any organization that (1) is not a Blue Cross or Blue Shield organization existing on August 16, 1986, and

(2) otherwise meets the requirements of section 833(c)(2) (including the requirement of no material change in operations or structure since August 16, 1986). Under the provision, an organization qualifies for this treatment only if (1) it is not a health maintenance organization and (2) it is organized under and governed by State laws which are specifically and exclusively applicable to not-for-profit health insurance or health service type organizations.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million per year.

G. Penalty-Free Withdrawals from IRAs for Medical Expenses (sec. 361 of HIPA and sec. 72(t) of the Code)

Present and Prior Law

Amounts withdrawn from an individual retirement arrangement ("IRA") are includible in income (except to the extent of any non-deductible contributions). In addition, a 10-percent additional tax applies to withdrawals from IRAs made before age 59-1/2, unless the withdrawal is made on account of death or disability or is made in the form of annuity payments.

A similar additional tax applies to early withdrawals from employer-sponsored tax-qualified pension plans. However, the 10-percent additional tax does not apply to withdrawals from such plans to the extent used for medical expenses that exceed 7.5 percent of adjusted gross income ("AGI").

Explanation of Provision

HIPA extends the exception to the 10-percent tax for medical expenses in excess of 7.5 percent of AGI to withdrawals from IRAs. In addition, HIPA provides that the 10-percent additional tax does not apply to withdrawals for medical insurance (without regard to the 7.5 percent of AGI floor) if the individual (including a self-employed individual) has received unemployment compensation under Federal or State law for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then, to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed.

The exception to the additional tax ceases to apply if the individual has been reemployed for at least 60 days.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1997, $10 million in each of 1998 through 2001, $11 million in each of 2002 through 2004, and $12 million in 2005 and 2006.

H. Require Treasury to Include Organ and Tissue Donation Information With Tax Refunds (sec. 371 of HIPA)

Prior Law

Under prior law, there was no statutory requirement that Treasury include organ and tissue donation information with the mailing of any payment of a refund of individual income taxes.

Reasons for Change

The Congress believed it was appropriate to include organ and tissue donation information with the mailing of these tax refunds.

Explanation of Provision

HIPA requires Treasury, to the extent practicable, to include organ and tissue donation information with the mailing of any payment of a refund of individual income taxes made on or after February 1, 1997, through June 30, 1997.

Effective Date

The provision is effective for refunds made on or after February 1, 1997, through June 30, 1997.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

II. APPLICATION AND ENFORCEMENT OF GROUP HEALTH PLAN REQUIREMENTS

A. Application and Enforcement of Group Health Plan Portability, Access, and Renewability Requirements (secs. 401-402 of HIPA and new secs. 9801-9806 of the Code)

Present and Prior Law

Under present and prior law, the health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that most employer-sponsored group health plans must offer certain employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the case of certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, or the end of a child's dependency under a parent's health plan. In general, the maximum period of COBRA coverage is 18 months. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage.

Under present and prior law, a tax is imposed on the failure of a group health plan to satisfy the COBRA rules.[249] The tax may be imposed on the employer sponsoring the plan in the case of a plan other than a multiemployer plan, on the plan in the case of a multiemployer plan, or on each person who is responsible for administering or providing benefits under the plan if such person has, by written agreement, assumed responsibility for performing the act pursuant to which the violation occurs. A group health plan is a plan (including a self-insured plan) of an employer or employee organization to provide health care to the employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families.

The amount of the tax is generally equal to $100 per day for each day on which there is a violation. The tax applies separately with respect to each qualified beneficiary for whom a failure occurs. In general, a tax will not be imposed if the violation was unintentional and is corrected within 30 days. The maximum tax for unintentional violations that can be imposed for a taxable year generally is the lesser of (1) 10 percent of the employer's payments under group health plans (or under the trust funding the plan in the case of a multiemployer plan), or (2) $500,000. If the tax is imposed on another person responsible for administering or providing benefits under the plan, the maximum penalty for failures during

[249] The tax does not apply to plans maintained by employers with less than 20 employees, governmental plans, or church plans. The health care continuation rules are also enforced through the Employee Retirement Income Security Act and the Public Health Service Act.

the year is $2 million. The Secretary of the Treasury may waive all or part of the tax to the extent that payment of the tax would be excessive relative to the failure involved.

Other than the COBRA rules, under prior law there were no other requirements in the Code which applied to group health plans (or insurers or HMOs) regarding portability through limitations on preexisting condition exclusions, prohibitions on excluding individuals from coverage based on health status, or guaranteed renewability of health plan coverage.

Reasons for Change

The Congress believed that the present-law sanctions for violations of the health care continuation rules would be an effective enforcement mechanism with respect to the provisions of the Act relating to portability, limitations on exclusion of preexisting conditions, and prohibitions on excluding individuals from coverage based on health status.

Explanation of Provision

In general

Under HIPA, certain group health plans are subject to certain requirements regarding portability through limitations on preexisting condition exclusions, prohibitions on excluding individuals from coverage based on health status, and guaranteed renewability of health insurance coverage. An excise tax is imposed with respect to any failure of a group health plan to comply with the requirements.[250] The tax is generally imposed on the employer sponsoring the plan. However, the tax is imposed on the plan in the case of a multiemployer plan and, with respect to violations of the requirements relating to guaranteed renewability, on the arrangement in the case of a multiple employer welfare arrangement.

The group health plan requirements contained in the Code do not apply to governmental plans and plans which on the first day of the plan year cover less than 2 current employees. In addition, no tax may be imposed on a small employer (defined as an employer who employed an average of 50 or fewer employees on business days during the preceding calendar year) that provides health care benefits through a contract with an insurer or HMO if the violation is solely because of the coverage offered by the insurer or HMO.

Group health plan requirements

Limitations on preexisting condition exclusions

HIPA restricts the use of preexisting condition limitation exclusions by group health plans. A preexisting condition exclusion is a limitation or exclusion of benefits relating to a condition, whether physical or mental, based on the fact that the condition was present before the enrollment date, whether or not any medical advice, diagnosis care, or treatment was recommended or received before that date. Genetic information is not considered a condition in

[250] HIPA also enforces these requirements through the Employee Retirement Income Security Act and the Public Health Service Act, and imposes similar and additional requirements on health insurance issuers.

the absence of a diagnosis of the condition related to such information.

HIPA permits a group health plan to impose a preexisting condition exclusion if the exclusion relates to a condition (whether physical or mental), regardless of the cause of condition, for which medical advice, diagnosis, care, or treatment was recommended or received within the 6-month period ending on the enrollment date. The exclusion can extend to not more than 12 months (18 months for late enrollees) after the enrollment date. The exclusion is reduced by the aggregate of the periods of creditable coverage. Enrollment date is defined as the date of enrollment in the plan or coverage or, if earlier, the first day of the waiting period for such enrollment.

Any waiting period or affiliation period runs concurrently with any preexisting condition exclusion period. A preexisting condition limitation period cannot be applied to a newborn, an adopted child or child placed for adoption under age 18, so long as the individual becomes covered under creditable coverage within 30 days of birth or adoption or placement for adoption. These exceptions for newborns and certain adopted children do not apply if the individual had a break in coverage longer than a 63-day period. Preexisting condition exclusions cannot apply to pregnancies.

A group health plan offering health insurance coverage through an HMO, or an HMO which offers health insurance coverage in connection with a group health plan, may impose an affiliation period only if no preexisting condition exclusion is imposed, the period is imposed uniformly without regard to health status, and does not exceed 2 months for timely enrollment and 3 months for late enrollment. It is intended that any affiliation period apply to all new enrollees and beneficiaries. During the affiliation period, the HMO cannot be required to provide health care services or benefits and no premium can be charged to the participant or beneficiary. The affiliation period begins on the enrollment date and runs concurrently with any other applicable waiting period under the plan. An HMO may use alternative methods to address adverse selection as approved by state regulators.

Prohibiting exclusions based on health status

Except as specified below, a group health plan cannot establish rules for eligibility (including continued eligibility) of an individual to enroll under the terms of the plan based on any of the following health-related factors in relation to the individual or a dependent of the individual: health status, medical condition (including both physical and mental illness), claims experience, receipt of health care, medical history, genetic information, evidence of insurability (including conditions arising out of domestic violence), or disability.

The inclusion of evidence of insurability in the definition of health status is intended to ensure, among other things, that individuals are not excluded from health care coverage due to their participation in activities such as motorcycling, snowmobiling, all-terrain vehicle riding, horseback riding, skiing and other similar activities.

It is intended that a plan cannot knowingly be designed to exclude individuals and their dependents on the basis of health sta-

tus. However, generally applicable terms of the plan may have a disparate impact on individual enrollees. For example, a plan may exclude all coverage of a specific condition, or may include a lifetime cap on all benefits, or a lifetime cap on specific benefits. Although individuals with the specific condition would be adversely affected by an exclusion of coverage for that condition, and individuals with serious illnesses may be adversely affected by a lifetime cap on all or specific benefits, such plan characteristics are permitted as long as they are not directed at individual sick employees or dependents.

HIPA does not require a group health plan to provide particular benefits other than those provided under the terms of the plan or coverage. Nor does it prevent any plan or coverage from establishing limitations or restrictions on the amount, level, extent, or nature of the benefits or coverage for similarly situated individuals enrolled in the plan or coverage. Rules defining any applicable waiting periods for enrollment may not be established based on health status related factors.

It is intended that a plan cannot single out an individual based on the health status or health status related factors of that individual for denial of a benefit otherwise provided other individuals covered under the plan. For example, the plan may not deny coverage for prescription drugs to a particular beneficiary or dependent if such coverage is available to other similarly situated individuals covered under the plan. However, the plan could deny coverage for prescription drugs to all beneficiaries and dependents. The term "similarly situated" means that a plan is permitted to vary benefits available to different groups of employees, such as full-time versus part-time employees or employees in different geographic locations. In addition, a plan may have different benefit schedules for different collective bargaining units.

HIPA provides that a group health plan cannot require a premium or contribution which is greater than such premium or contribution for a similarly situated individual enrolled in the plan on the basis of any health status-related factor relating to the individual or to any individual enrolled under the plan as a dependent of the individual. It does not restrict the amount that an employer may be charged for coverage under a group health plan. The group health plan may establish premium discounts or rebates, or modify otherwise applicable copayments or deductibles in return for adherence to programs of health promotion and disease prevention.

It is intended that these provisions preclude insurance companies from denying coverage to employers based on health status and related factors that they have traditionally used. In addition, this provision is meant to prohibit insurers or employers from excluding employees in a group from coverage or charging them higher premiums based on their health status and other related factors that could lead to higher health costs. This does not mean that an entire group cannot be charged more. But it does preclude health plans from singling out individuals in the group for higher premiums or dropping them from coverage altogether.

Guaranteed renewability in multiemployer plans and certain multiple employer welfare arrangements

HIPA provides that a group health plan which is a multiemployer plan or a multiple employer welfare arrangement may not deny an employer continued access to the same or different coverage under the terms of such plan except: (1) for nonpayment of contributions; (2) for fraud; (3) for noncompliance with plan provisions; (4) because the plan is ceasing to offer any coverage in a geographic area; (5) in the case of a network plan, there is no longer any individual enrolled through the employer who lives, resides, or works in the service area of the network plan, and the plan applies this provision uniformly without regard to claims experience or health status-related factors; or (6) due to a failure to meet the terms of an applicable collective bargaining agreement, to renew a collective bargaining agreement or other agreement requiring or authorizing contributions to the plan, or to employ employees covered by such an agreement.

Excise tax on failure to satisfy group health plan requirements

The excise tax on the failure to satisfy the group health plan requirements is generally equal to $100 per day for each day during which a failure occurs until the failure is corrected. The tax applies separately with respect to each individual affected by the failure. In general, the tax is not imposed if the violation was unintentional and is corrected within 30 days.[251] The maximum tax for unintentional violations that can be imposed generally is the lesser of (1) 10 percent of the employer's payments during the taxable year in which the failure occurred under group health plans (or 10 percent of the amount paid by the multiemployer plan or multiple employer welfare arrangement during the plan year in which the failure occurred for medical care, if applicable), or (2) $500,000. The Secretary of the Treasury may waive all or part of the tax to the extent that payment of the tax would be excessive relative to the failure involved.

Effective Date

The group health plan requirements are effective with respect to plan years beginning after June 30, 1997. The excise tax applies to failures to satisfy the group health plan rules.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

[251] In the case of a church plan, this correction is generally extended to 270 days after the date of mailing by the Secretary of the Treasury of a notice of default with respect to a failure to comply with the group health plan requirements.

B. Clarification of Certain COBRA Health Care Continuation Requirements (sec. 421 of HIPA and sec. 4980B of the Code)

Present and Prior Law

Under present and prior law, the health care continuation rules (commonly referred to as "COBRA" rules, after the Consolidated Omnibus Budget Reconciliation Act of 1985 in which they were enacted) require that most employer-sponsored group health plans must offer certain employees and their dependents ("qualified beneficiaries") the option of purchasing continued health coverage in the case of certain qualifying events. These qualifying events include: termination or reduction in hours of employment, death, divorce or legal separation, enrollment in Medicare, the bankruptcy of the employer, or the end of a child's dependency under a parent's health plan. In general, the maximum period of COBRA coverage is 18 months. An employer is permitted to charge qualified beneficiaries 102 percent of the applicable premium for COBRA coverage. A $100 per day tax generally may be assessed against employers (plans in the case of multiemployer plans) for failures to comply with the COBRA rules, subject to certain exceptions and limitations.

Under prior law, the 18-month maximum COBRA coverage period was extended to 29 months if the qualified beneficiary was determined under the Social Security Act to have been disabled at the time of the qualifying event and the qualified beneficiary provided notice of such determination to the employer before the end of the 18-month period. Under present and prior law a qualified beneficiary has 60 days to notify the employer of a disability determination. During the 11-month period of extended COBRA coverage, the qualified beneficiary may be charged 150 percent of the applicable premium.

Under present and prior law, COBRA coverage may be terminated before the 18-month maximum coverage period in the case of certain events. These include: the employer ceases to maintain any group health plan, the qualified beneficiary fails to pay the premium, the qualified beneficiary becomes covered under another group health plan with no preexisting condition limitation or exclusion, or the qualified beneficiary becomes entitled to Medicare.

Under prior law, the term qualified beneficiary only included individuals who were either the spouse or the dependent of the covered employee at the time of the qualifying event. Newborns and adopted children are not eligible until the plan's next open enrollment period.

Under present and prior law, a group health plan is required to notify each covered employee and the covered employee's spouse of their COBRA rights upon commencement of participation in the plan. Further, the group health plan administrator must notify each qualified beneficiary of their COBRA rights within 14 days after the administrator is notified of the occurrence of a qualifying event.

Reasons for Change

The Congress believed it appropriate to modify COBRA to minimize gaps in health coverage for newborns and adopted children and individuals with disabilities. In addition, Congress believed it appropriate to amend COBRA to avoid unnecessary duplicative coverage in the case of persons who would be eligible for coverage under the portability provisions of the bill.

Explanation of Provision

HIPA modifies the COBRA rules by clarifying that the extended maximum COBRA coverage period of 29 months in cases of disability also applies to the nondisabled qualified beneficiary. HIPA provides the extended COBRA coverage if the disability exists at any time during the first 60 days of initial 18-month COBRA coverage period as opposed to requiring the disability to exist at the time of the qualifying event. As under prior law, the disability determination still has to be made, and the notice of the disability still has to be given, before the end of the initial COBRA coverage period.

HIPA also modifies the definition of qualified beneficiary to include a child born to or placed for adoption with the covered employee during the period of COBRA coverage. Since the health care availability provisions in the Act require group health plans to allow participants to change their coverage status (i.e., to change from individual coverage to family coverage, or to add on the new child) upon the birth or adoption (or placement for adoption) of a new child, COBRA participants would also be allowed to change their coverage status upon the birth or adoption of a new child.

HIPA requires a group health plan to have notified each qualified beneficiary who has elected COBRA coverage of the changes to the COBRA rules contained in HIPA no later than November 1, 1996.

HIPA coordinates the COBRA rules with the new requirements regarding preexisting condition exclusions so that COBRA coverage can be terminated if a qualified beneficiary becomes covered under another group health plan, even if such group health plan contains a preexisting condition limitation or exclusion, provided the preexisting condition limitation or exclusion does not apply to the qualified beneficiary by reason of the new requirements restricting the application of preexisting condition limitations and exclusions.

Effective Date

The provision is effective on January 1, 1997, regardless of whether the qualifying event occurred before, on, or after such date.

Revenue Effect

The provision is estimated to have no effect on Federal fiscal year budget receipts.

III. REVENUE OFFSETS

A. Disallow Interest Deduction for Corporate-Owned Life Insurance Policy Loans (sec. 501 of HIPA and sec. 264 of the Code)

Present and Prior Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[252] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)). Under prior law, the policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations.

The limitations on borrowing with respect to a life insurance contract under prior and present law provide that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual who (1) is an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such debt with respect to policies covering the individual exceeds $50,000 (sec. 264(a)(4)).[253]

Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract.[254] An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). Provided the

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[252] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A).

[253] The statute provides that the $50,000 limitation applies only with respect to contracts purchased after June 20, 1986.

[254] Under prior and present law, additional limitations are imposed on the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)), and on the deductibility of premiums paid on a life insurance contract covering the life of any officer or employee or person financially interested in a trade or business of the taxpayer when the taxpayer is directly or indirectly a beneficiary under the contract (sec. 264(a)(1)).

transaction gave rise to debt for Federal income tax purposes, and provided the 4-out-of-7 rule is met,[255] a company could under prior law borrow up to $50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and not be precluded under section 264 from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

Reasons for Change

Considerable publicity has been focused on the magnitude of business borrowings with respect to life insurance and the scale of the tax benefits. In a recent article describing corporate-owned life insurance ("COLI"), it was stated, "COLIs can net big bucks. After 40 years, a COLI program that pays a $10,000 annual premium on each of 5,000 employees will produce about $450 million in death benefits and $300 million in tax benefits—netting the company $230 million."[256]

A company that sets up a COLI program typically purchases life insurance on the lives of its employees, in many cases thousands or tens of thousands of employees.[257] The company, not the employee or his family, receives all or most of the proceeds on the employee's death. The company borrows against the value of the life insurance policies at an interest rate just above the rate at which inside buildup is credited under the policy. The interest that the company pays on policy loans from the insurer is credited under the policy and increases the tax-free inside buildup. At the same time, the company deducts the interest it pays. The company shows a positive return on the COLI program, because the after-tax interest it pays on the policy loan is less than the interest income being credited under the policy. In addition, tax-free death benefits that the company receives on the death of insured employees subsidize future years' premiums. The company is able to increase the value of its life insurance contract while using funds borrowed under the insurance contract for other purposes.[258] Large COLI programs could be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest.

Congress believed that these types of transactions are an inappropriate use of the tax rules and achieve a result that was never contemplated by Congress. When the $50,000 limitation of present

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[255] Interest deductions are disallowed if any of the disallowance rules of section 264(a)(2)–(4) apply. The disallowance rule of section 264(a)(3) is not applicable if one of the exceptions of section 264(c), such as the 4-out-of-7 rule (sec. 264(c)(1)) is satisfied. In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

[256] Solov, Diane, "Companies Profit By Insurance," *St. Paul Pioneer Press*, p. 2E, March 20, 1995. See also Lee Sheppard, "'Janitor' Insurance as a Tax Shelter," *Tax Notes*, p. 1526, September 25, 1995.

[257] In cases in which the employer has an insurable interest in an employee when the policy is issued, State law generally provides that an employer continues to have an insurable interest in former employees even after the termination of their employment. Thus, this life insurance coverage may be continued after an employee terminates employment with an employer, creating an ever-increasing pool of lives.

[258] Companies sometimes use the funds borrowed under the life insurance contracts for tax-advantaged funding of expenses such as retiree health benefits and nuclear decommissioning expenses, even though Congress has already provided special tax benefits specifically for funding these expenses.

law was enacted, it was not anticipated that it would lead to a trend in the purchase of insurance products covering hundreds, thousands or even hundreds of thousands of employees of a business organization in order to maximize the tax arbitrage of deducting interest that is credited, tax-free, to the organization's own insurance contract.

In addition, Congress felt that it is not appropriate to permit a deduction for interest that is funding the increase in value of an asset of which the taxpayer is the ultimate beneficiary, as recipient of the proceeds upon the insured person's death. Interest paid by the taxpayer on a loan under a life insurance policy can be viewed as funding the inside buildup of the policy. The taxpayer is indirectly paying the interest to itself, through the increase in value of the policy of which the taxpayer is the beneficiary.

A general principle of accurate income measurement under an income tax system provides that expenses, such as interest, are not deducted from income if they are costs of accretions to wealth that are not included in income. Congress took note that numerous provisions of the tax law limit the deductibility of interest (as well as other expenses) relating to income that is not subject to tax. For example, interest incurred or continued to purchase or carry tax-exempt bonds is not deductible (sec. 265(a)(2)). As a further example, proration rules apply to insurance companies and financial institutions such as banks, designed to limit deductions funded by tax-exempt income (secs. 805(a)(4), 832(b)(5)(B), and 265(b)). Personal interest of individuals is not deductible (secs. 163(h))[259]. The absence of any such limitation under present law with respect to companies' borrowings under life insurance contracts creates a significant tax incentive under present law for companies to purchase life insurance contracts rather than investing in other assets. To be consistent with the principle of accurate income measurement, and to limit the economic distortion induced by present law, it is appropriate to limit the deductibility of interest on debt that relates to the earning of inside buildup.

Therefore, the provision generally disallows any deduction for interest on borrowing by businesses with respect to life insurance, endowment and annuity products covering persons in whom the taxpayer has an insurable interest, subject to a phase-in of the disallowance rule. Congress believed, however, that it is appropriate to provide an exception (retaining the $50,000 ceiling of prior law) for borrowing with respect to life insurance covering a limited number of key persons, to the extent that the interest rate on such borrowing does not exceed a market rate of interest. HIPA does not limit the ability of business taxpayers to insure key persons, but deductible interest on borrowing is permitted on no more than 20 such persons, because Congress did not want borrowing on life insurance policies to be used as a tax shelter. In addition, Congress believed it is appropriate to continue the grandfather treatment

[259] Congress has specifically permitted a deduction for home mortgage interest. In providing the home mortgage interest deduction, Congress noted that encouraging home ownership is an important policy goal. Borrowing under a life insurance policy, by contrast, conflicts with a policy goal to encourage the purchase of life insurance so that breadwinners provide after their death for their dependents, because the proceeds of life insurance are reduced by the amount of any loans outstanding at the time of the insured person's death. Interest on a loan to purchase a life insurance policy is nondeductible personal interest of an individual.

provided when the $50,000 limit was imposed in 1986, subject to a market interest rate cap. HIPA provides additional transition relief by permitting a 4-year spread of income resulting from the complete surrender, redemption or maturity of a policy or a refund of the consideration paid for a policy during 1996, 1997 or 1998.

Explanation of Provision

Under HIPA, subject to an exception for key person insurance, no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.[260]

An exception is provided retaining present law for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. It is intended that employees be full-time employees, for this purpose. A 20-percent owner is an individual who directly owns 20 percent or more of the total combined voting power of the corporation. If the taxpayer is not a corporation, a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the taxpayer. It was not intended that indirect ownership interests be attributed to an individual for this purpose. For determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. The 20-person limit may be allocated among members of the controlled group as provided in regulations. In the absence of such guidance, the 20-person limit is to be allocated among members of a group in a reasonable manner. Interest paid or accrued on debt with respect to a life insurance contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued.

In promulgating regulations or other guidance under the provision, it was anticipated that the Treasury Department will take into account the purpose of the provision to eliminate the deduction for interest on borrowing by businesses with respect to life insurance, endowment and annuity products covering persons in whom the taxpayer has an insurable interest. For example, it was not intended that a taxpayer should be able to circumvent the purpose of the provision by borrowing under a life insurance, endowment or annuity contract with respect to a director who is not also an officer of the taxpayer.

[260] The provision disallows the deduction for interest even if the deduction would not be disallowed under any other rule. Thus, for example, if a deduction would not be disallowed under section 264(a)(3) because the 4-out-of-7 rule is met, this provision nevertheless disallows the deduction.

Effective Date

The provision generally is effective with respect to interest paid or accrued after December 31, 1995 (subject to a phase-in rule).

The phase-in rule provides that with respect to debt incurred before January 1, 1996, any otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, is allowed to the extent the rate of interest does not exceed the lesser of (1) the borrowing rate specified in the contract as of October 13, 1995, or (2) a percentage of Moody's Corporate Bond Yield Average—Monthly Average Corporates for each month the interest is paid or accrued. For interest paid or accrued after December 31, 1995, and before January 1, 1997, the percentage of the Moody's rate is 100 percent; for interest paid or accrued in 1997, the percentage is 90 percent; for interest paid or accrued in 1998, the percentage is 80 percent; for 1999 and thereafter, the percentage is 0 percent. Only interest that would have been allowed as a deduction but for the provision is allowed under the phase-in. Interest that is deductible under the phase-in rules does not include interest on borrowings by the taxpayer with respect to contracts on the lives of more than 20,000 insured individuals, effective for interest paid or accrued after December 31, 1995. For this purpose, all persons treated as a single employer are treated as one taxpayer.

An exception is provided under the effective date with respect to any life insurance contract entered into during 1994 or 1995. In the case of such contracts, with respect to debt incurred before January 1, 1997, a deduction is allowed for interest (that is otherwise deductible) only (1) with respect to policies that satisfy the key person exception, and (2) as provided under the phase-in rule. Thus, with respect to interest on amounts borrowed during 1996 with respect to such a contract, the phase-in rule applies, capping the rate for determining the amount of deductible interest at the lesser of (1) the borrowing rate specified in the contract as of October 13, 1995, or (2) the applicable percentage of Moody's Corporate Bond Yield Average—Monthly Average Corporates for each month the interest is paid or accrued. For example, for interest paid or accrued in 1996 on amounts borrowed in 1996 with respect to such a contract, the applicable percentage is 100 percent.

The provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986 (thus generally continuing the effective date provision of the $50,000 limitation enacted in the 1986 Act). If the policy loan interest rate under such a contract provides for a fixed rate of interest,[261] then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the fixed rate of interest does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates for the month in which the contract was purchased. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the rate of interest for each fixed period selected by the tax-

[261] See colloquy between Senators Hatch and Roth, 142 Cong. Rec. S9521 (Aug. 2, 1996).

payer[262] does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less. It was intended that conforming a contract to satisfy this interest rate limitation not be treated as a material modification for purposes of this grandfather rule or sections 101(f), 7702 or 7702A. No inference was intended as to whether such a change is a material modification under prior law.

Any amount included in income during 1996, 1997, or 1998, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, is includable ratably over the first 4 taxable years beginning with the taxable year the amount would otherwise have been includable. Utilization of this 4-year income-spreading rule does not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1) (i.e., a contract in which substantially all of the premiums are paid within 4 years after the date of purchase). In addition, the lapse[263] of a contract after October 13, 1995, due to nonpayment of premiums does not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1).

In the case of an insurance company, the unamortized balance of policy expenses attributable to a contract with respect to which the 4-year income-spreading treatment is allowed to the policyholder is deductible in the year in which the transaction giving rise to income-spreading occurs.

No inference was intended as to the treatment of interest paid or accrued under prior law.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $726 million in 1997, $833 million in 1998, $1,356 million in 1999, $1,707 million in 2000, $1,784 million in 2001, $1,879

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[262] The election of a period with respect to a contract is to be made on the taxpayer's income tax return for its first taxable year ending on or after October 13, 1995. If the election was not made on the taxpayer's return for that taxable year, then it is intended that the election be permitted to be made in a manner provided in Treasury Department guidance. If no election is made, then it is intended that the taxpayer be deemed to have elected a 12-month period.

[263] The provision states that the relief is provided in the following case: solely by reason of no additional premiums being received by reason of a lapse. It is intended that the lapse be by reason of no additional premiums being received with respect to the contract. Thus, the provision is intended to provide relief when no additional premiums are received with respect to the contract. The relief under the provision is intended to apply in the case of a contract that is converted to extended term insurance or reduced paid-up insurance pursuant to nonforfeiture provisions, so long as no additional premiums are received with respect to the contract. For purposes of this provision, a contract is not intended to be treated as one with respect to which no additional premiums are received if it was a contract, interest on borrowing under which is subject to limitation under the provision, but the contract is treated as exchanged for Federal tax purposes because of a material change (for example, terms of the contract have been renegotiated), and premiums are paid on the contract treated as received by the policyholder in the exchange.

million in 2002, $1,919 million in 2003, $1,930 million in 2004, $1,924 million in 2005, and $1,921 million in 2006.

B. Expatriation Tax Provisions (secs. 511-513 of HIPA and secs. 877, 2107, and 2501 and new sec. 6039F of the Code)

Present and Prior Law

Taxation of United States citizens, residents, and non-residents

Individual income taxation

Income taxation of U.S. citizens and residents

In general

A United States citizen generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[264] All income earned by a U.S. citizen, from sources inside and outside the United States, is taxable, whether or not the individual lives within the United States. A non-U.S. citizen who resides in the United States generally is taxed in the same manner as a U.S. citizen if the individual meets the definition of a "resident alien," described below.

The taxable income of a U.S. citizen or resident is equal to the taxpayer's total income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits. When an individual disposes of property, any gain or loss on the disposition is determined by reference to the taxpayer's cost basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a citizen or resident of the United States.

If a U.S. citizen or resident earns income from sources outside the United States, and that income is subject to foreign income taxes, the individual generally is permitted a foreign tax credit against his or her U.S. income tax liability to the extent of foreign income taxes paid on that income.[265] In addition, a United States citizen who lives and works in a foreign country generally is permitted to exclude up to $70,000 of annual compensation from being subject to U.S. income taxes, and is permitted an exclusion or deduction for certain housing expenses.[266]

Resident aliens

In general, a non-U.S. citizen is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—183 or more days during a 3-year pe-

[264] The determination of who is a U.S. citizen for tax purposes, and when such citizenship is lost, is governed by the provisions of the Immigration and Nationality Act, 8 U.S.C. section 1401, et seq. See Treas. Reg. section 1.1-1(c).
[265] See sections 901-907.
[266] Section 911.

riod weighted toward the present year (the "substantial presence test").[267]

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year, the individual generally is not subject to U.S. tax as a resident on account of the substantial presence test. If an individual is present for 183 days or more during a calendar year, this closer connections/tax home exception is not available. An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident is not eligible for the closer connections/tax home exception.

For purposes of applying the substantial presence test, any days that an individual is present as an "exempt individual" are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States, if the individual can establish to the satisfaction of the Secretary of the Treasury that he or she qualifies for this special medical exception.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of "tie-breaker" rules to determine the individual's country of residence for income tax purposes. In general, a dual resident is deemed to be a resident of the country in which such person has a permanent home. If the individual has a permanent home available in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., the "center of vital interests.") If the country in which such individual has his or her center of vital interests cannot be determined, or if such individual does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a citizen. If each country considers the person to be its citizen or if he or she is a citizen of neither country, the competent authorities of the countries are to settle the question of residence by mutual agreement.

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[267] The definitions of resident and nonresident aliens are set forth in section 7701(b). The substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. Presence for 122 days (or more) per year over the 3-year period would constitute substantial presence under the test.

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Income taxation of nonresident aliens

Non-U.S. citizens who do not meet the definition of "resident aliens" are considered to be nonresident aliens for tax purposes. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

A nonresident alien is taxed at regular graduated rates on net profits derived from a U.S. business.[268] Nonresident aliens also are taxed at a flat rate of 30 percent on certain types of passive income derived from U.S. sources, although a lower rate may be provided by treaty (e.g., dividends are frequently taxed at a reduced rate of 15 percent). Such passive income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. There is no U.S. tax imposed, however, on interest earned by nonresident aliens with respect to deposits with U.S. banks and certain types of portfolio debt investments.[269] Gains on the sale of stocks or securities issued by U.S. persons generally are *not* taxable to a nonresident alien because they are considered to be foreign source income.[270]

Nonresident aliens are subject to U.S. income taxation on any gain recognized on the disposition of an interest in U.S. real property.[271] Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. If a U.S. real property interest is acquired from a foreign person, the purchaser generally is required to withhold 10 percent of the amount realized (gross sales price). Alternatively, either party may request that the Internal Revenue Service ("IRS") determine the transferor's maximum tax liability and issue a certificate prescribing a reduced amount of withholding (not to exceed the transferor's maximum tax liability).[272]

Estate and gift taxation

The United States imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident,[273] whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. No gift tax is imposed, how-

[268] Section 871.
[269] See sections 871(h) and 871(i)(3).
[270] Section 865(a).
[271] Sections 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)).
[272] Section 1445.
[273] Section 2501.

ever, on gifts made by nonresident aliens of intangible property having a situs within the United States (e.g., stocks and bonds).[274]

The United States also imposes an estate tax on the worldwide "gross estate" of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death.[275]

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a U.S. citizen or resident during his or her lifetime and at death. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million.[276] A unified credit of $192,800 is available with respect to taxable transfers by gift and at death. The unified credit effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax.

Residency for purposes of estate and gift taxation is determined under different rules than those applicable for income tax purposes. In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States. An individual is domiciled in the United States if the individual (a) is living in the United States and has the intention to remain in the United States indefinitely; or (b) has lived in the United States with such an intention and has not formed the intention to remain indefinitely in another country. In the case of a U.S. citizen who resided in a U.S. possession at the time of death, if the individual acquired U.S. citizenship solely on account of his birth or residence in a U.S. possession, that individual is not treated as a U.S. citizen or resident for estate tax purposes.[277]

In addition to the estate and gift taxes, a separate transfer tax is imposed on certain "generation-skipping" transfers.

Special tax rules with respect to the movement of persons and property into or out of the United States

Individuals who relinquish U.S. citizenship with a principal purpose of avoiding U.S. tax

An individual who relinquishes his or her U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for the period of the 10 taxable years ending after expatriation under section 877.[278] Under prior law, if the Treasury Department established that it was reasonable to believe that the expatriate's loss of U.S. citizenship would, but for the application of this provision, result in a substantial reduc-

[274] Section 2501(a)(2).

[275] Sections 2001, 2031, 2101, and 2103.

[276] Section 2001(c).

[277] Section 2209.

[278] Treasury regulations provide that an individual's citizenship status is governed by the provisions of the Immigration and Nationality Act, specifically referring to the "rules governing loss of citizenship [set forth in] sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489)." Treas. Reg. section 1.1-1(c). Under the Immigration and Nationality Act, an individual is generally considered to lose U.S. citizenship on the date that an expatriating act is committed. The present-law rules governing the loss of citizenship, and a description of the types of expatriating acts that lead to a loss of citizenship, are discussed more fully below.

tion in U.S. tax based on the expatriate's probable income for the taxable year, then the expatriate had the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. Under prior law, section 877 did *not* apply to resident aliens who terminated their U.S. residency.

The alternative method modified the rules generally applicable to the taxation of nonresident aliens in two ways. First, the expatriate is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. (Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on foreign source income.) Second, the scope of items treated as U.S. source income for section 877 purposes is broader than those items generally considered to be U.S. source income under the Code. For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S. source income under the Code. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S. source income with respect to that individual. The alternative method applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

Because section 877 alters the sourcing rules generally used to determine the country having primary taxing jurisdiction over certain items of income, there was an increased potential for such items to be subject to double taxation. For example, a former U.S. citizen subject to the section 877 rules may have capital gains derived from stock in a U.S. corporation. Under section 877, such gains are treated as U.S. source income, and were, therefore, subject to U.S. tax. Under the internal laws of the individual's new country of residence, however, that country may provide that all capital gains realized by a resident of that country are subject to taxation in that country, and thus the individual's gain from the sale of U.S. stock also would be taxable in his or her country of residence. If the individual's new country of residence has an income tax treaty with the United States, the treaty may provide for the amelioration of this potential double tax.

Similar rules apply in the context of estate and gift taxation if the transferor relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. A special rule is applied to the estate tax treatment of any decedent who relinquished his or her U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.[279] Once the Secretary of the Treasury established a reasonable belief that the expatriate's loss of U.S. citizenship would result in a substantial reduction in estate, inheritance, legacy and succession taxes, the burden of proving that one of the principal purposes of the loss of U.S. citizenship was *not* avoidance of U.S. income or estate tax was on the executor of the decedent's estate.

[279] Section 2107.

In general, the estates of individuals who have relinquished U.S. citizenship are taxed in accordance with the rules generally applicable to the estates of nonresident aliens (i.e., the gross estate includes all U.S.-situs property held by the decedent at death, is subject to U.S. estate tax at the rates generally applicable to the estates of U.S. citizens, and is allowed a unified credit of $13,000, as well as credits for State death taxes, gift taxes, and prior transfers). However, a special rule provided that the individual's gross estate also includes his or her pro-rata share of any U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater voting interest, provided that the decedent and related parties together owned more than 50 percent of the voting power of the corporation. Similarly, gifts of intangible property having a situs within the United States (e.g., stocks and bonds) made by a nonresident alien who relinquished his or her U.S. citizenship within the 10-year period ending on the date of transfer are subject to U.S. gift tax, if the loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.[280]

Aliens having a break in residency status

A special rule applies in the case of an individual who has been treated as a resident of the United States for at least three consecutive years, if the individual becomes a nonresident but regains residency status within a three-year period.[281] In such cases, the individual is subject to U.S. tax for all intermediate years under the section 877 rules described above (i.e., the individual is taxed in the same manner as a U.S. citizen who renounced U.S. citizenship with a principal purpose of avoiding U.S. taxes). The special rule for a break in residency status applies regardless of the subjective intent of the individual.

Transfers to foreign corporations

Certain transfers of property by shareholders to a controlled corporation are generally tax-free if the persons transferring the property own at least 80 percent of the corporation after the transfer.[282] Also, in certain corporate reorganizations, including qualifying acquisitions and dispositions, shareholders of one corporation may exchange their stock or securities for stock or securities of another corporation that is a party to the reorganization without a taxable event except to the extent they receive cash or other property that is not permitted stock or securities. In addition, a corporation may transfer property to another corporation that is a party to the reorganization without a taxable event, except to the extent certain non-permitted consideration is received.[283] A liquidation of an 80-percent owned corporate subsidiary into its parent corporation is also generally tax-free.[284]

Under the rules applicable to these types of transfers, property transferred to a corporation retains its basis, to the extent the transfer was tax-free, so that any appreciation (i.e., built-in gain)

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[280] Section 2501(a)(3).
[281] Section 7701(b)(10).
[282] Section 351.
[283] Sections 368, 354, 356, and 361. (See also sec. 355.)
[284] Section 332.

will be subject to tax if the property is subsequently sold by the recipient corporation. Similarly, a shareholder who exchanges stock of one corporation for stock of another retains his or her original basis so that a subsequent sale of the acquired stock can produce a taxable gain.

Section 367 applies special rules, however, if property is transferred by a U.S. person to a foreign corporation in a transaction that would otherwise be tax-free under these provisions. These special rules are generally directed at situations where property is transferred to a foreign corporation, outside of the U.S. taxing jurisdiction, so that a subsequent sale by that corporation could escape U.S. tax notwithstanding the carryover basis of the asset. In some instances, such a transfer causes an immediate taxable event so that the generally applicable tax-free rules are overridden. In other instances, the taxpayer may escape immediate tax by entering a gain recognition agreement ("GRA") obligating the taxpayer to pay tax if the property is disposed of within a specified time period after the transfer. The GRA rules generally require the taxpayer to agree to file an amended return for the year of the original transfer if the property is disposed of by the transferee (including payment of interest from the due date of the return for the year of the original transfer to the time the additional tax under the agreement is actually paid following the disposition).

Section 367 also imposes rules directed at situations where a U.S. person has an interest in a foreign corporation, such as a controlled foreign corporation ("CFC") meeting specific U.S. shareholder ownership requirements, that could result in the U.S. person being taxed on its share of certain foreign corporate earnings. These rules are designed to prevent the avoidance of tax in circumstances where a reorganization or other nonrecognition transaction restructures the stock or asset ownership of the foreign corporation so that the technical requirements for imposition of U.S. tax on foreign earnings under the CFC or other rules are no longer met and there is therefore potential for removing the earnings of the original CFC from current or future U.S. tax, or changing the character of the earnings for U.S. tax purposes (e.g., from dividend to capital gain).

The rules of section 367 do not generally apply unless there is a transfer by a U.S. person to a foreign corporation, or unless a foreign corporation of which a U.S. person is a shareholder engages in certain transactions. Because an individual who expatriates is no longer a U.S. person, section 367 has no effect on actions taken by such individuals after expatriation. The Treasury Department has considerable regulatory authority under section 367 to address situations that may result in U.S. tax avoidance. For example, section 367(b) provides that any of certain tax-free corporate transactions that do not involve a transfer of property from a U.S. person (described in section 367(a)(1)) can be recharacterized as taxable "to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." The legislative history of this provision suggests that it was directed principally at situations involving

avoidance of U.S. tax on foreign earnings and profits;[285] however, the statutory language is quite broad and was provided in conjunction with the general rules taxing certain transfers by U.S. persons.

Under the existing section 367 regulations and the expatriation provisions of prior law, a U.S. person who expatriated, even for a principal purpose of avoiding U.S. tax, could subsequently engage in transactions that involve the transfer of property to a foreign corporation without any adverse consequences under section 367, since expatriation (even for a principal purpose of tax avoidance) is not an event covered by section 367 or the current regulations under that section. Similarly, a U.S. person who has expatriated is not considered a U.S. shareholder for purposes of applying the rules that address restructurings of foreign corporations with U.S. shareholders. By engaging in such a transaction, a taxpayer that expatriated could transfer assets that would otherwise generate income which would be subject to tax under section 877 into a foreign corporation, thus transforming the income into non-U.S. source income not subject to tax under section 877. For example, under section 877, if a principal purpose of tax avoidance existed, an expatriate would be taxed for 10 years on any sale of U.S. corporate stock. However, after expatriation, the person would no longer be a U.S. person for purposes of section 367, and thus generally could have transferred U.S. corporate stock to a foreign corporation controlled by the expatriate under section 351 without any section 367 effect. The foreign corporation generally could have then sold the U.S. corporate stock within the 10-year period, but the gain would not have been subject to U.S. tax.

In addition, the IRS or Treasury might encounter difficulties enforcing a gain recognition agreement if a U.S. person who has entered into such an agreement to pay tax on a later disposition of an asset subject to the agreement and then expatriates. The GRA regulations contain provisions requiring security arrangements if a U.S. natural person who has entered an agreement dies (or if a U.S. entity goes out of existence) but these provisions do not apply if a U.S. natural person expatriates.[286]

Even if an individual was subject to the alternative taxing method of section 877 (because the person expatriated with a principal purpose of avoiding U.S. tax), section 877 did not impose a tax on foreign source income. Thus, such an individual could have expatriated and subsequently transferred appreciated property to a foreign corporation or other entity beyond the U.S. taxing jurisdiction, without any U.S. tax being imposed on the appreciation under section 877.

Similar issues existed under section 1491 of the Code. Section 1491 imposes a 35-percent tax on otherwise untaxed appreciation when appreciated property is transferred by a U.S. citizen or resident, or by a domestic corporation, partnership, estate or trust, to certain foreign entities in a transaction not covered by section 367. In some cases, taxpayers may elect to enter into a gain recognition agreement (rather than pay immediate tax) pursuant to section

[285] See, e.g., H. Rept. 94-658, pp. 239-248 (94th Cong. 1st Sess, 1975); S. Rept. 94-938, pp. 261-271 (94th Cong., 2d Sess, 1976); H. Rept. 94-1515, p. 463 (94th Cong., 2d Sess., 1976)

[286] See, e.g., Temp. Reg. section 1.367(a)-3T(g)(9) and (10), Notice 87-85, 1987-2 C.B. 395.

1492.[287] As in the case of section 367, an individual who expatriated is no longer a U.S. citizen and may also no longer be a U.S. resident; thus, a transfer by such a person would be unaffected by section 1491.

Requirements for United States citizenship, immigration, and visas

United States citizenship

An individual may acquire U.S. citizenship in one of three ways: (1) being born within the geographical boundaries of the United States; (2) being born outside the United States to at least one U.S. citizen parent (as long as that parent had previously been resident in the United States for a requisite period of time); or (3) through the naturalization process. All U.S. citizens are required to pay U.S. income taxes on their worldwide income. The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens.

A U.S. citizen may voluntarily give up his or her U.S. citizenship at any time by performing one of the following acts ("expatriating acts") with the intention of relinquishing U.S. nationality: (1) becoming naturalized in another country; (2) formally declaring allegiance to another country; (3) serving in a foreign army; (4) serving in certain types of foreign government employment; (5) making a formal renunciation of nationality before a U.S. diplomatic or consular officer in a foreign country; (6) making a formal renunciation of nationality in the United States during a time of war; or (7) committing an act of treason.[288] An individual who wishes formally to renounce citizenship (item (5), above) must execute an Oath of Renunciation before a consular officer, and the individual's loss of citizenship is effective on the date the oath is executed. In all other cases, the loss of citizenship is effective on the date that the expatriating act is committed, even though the loss may not be documented until a later date. The State Department generally documents loss in such cases when the individual acknowledges to a consular officer that the act was taken with the requisite intent. In all cases, the consular officer abroad submits a certificate of loss of nationality ("CLN") to the State Department in Washington, D.C. for approval.[289] Upon approval, a copy of the CLN is issued to the affected individual. However, the date upon which the CLN is approved is not the effective date for loss of citizenship.

Before a CLN is issued, the State Department reviews the individual's files to confirm that: (1) the individual was a U.S. citizen; (2) an expatriating act was committed; (3) the act was undertaken voluntarily; and (4) the individual had the intent of relinquishing citizenship when the expatriating act was committed. If the expatriating act involved an action of a foreign government (for example, if the individual was naturalized in a foreign country or joined a foreign army), the State Department will not issue a CLN until it has obtained an official statement from the foreign government

[287] See, e.g., PLR 9103033.
[288] 8 U.S.C. section 1481.
[289] 8 U.S.C. section 1501.

confirming the expatriating act. If a CLN is not issued because the State Department does not believe that an expatriating act has occurred (for example, if the requisite intent appears to be lacking), the issue is likely to be resolved through litigation. Whenever the loss of U.S. nationality is put in issue, the burden of proof is on the person or party claiming that a loss of citizenship has occurred to establish, by a preponderance of the evidence, that the loss occurred.[290] Similarly, if a CLN has been issued, but the State Department later discovers that such issuance was improper (for example, because fraudulent documentation was submitted, or the requisite intent appears to be lacking), the State Department could initiate proceedings to revoke the CLN. If the recipient is unable to establish beyond a preponderance of the evidence that citizenship was lost on the date claimed, the CLN would be revoked. To the extent that the IRS believes a CLN was improperly issued, the IRS could present such evidence to the State Department and request that revocation proceedings be commenced. If it is determined that the individual has indeed committed an expatriating act, the date for loss of citizenship will be the date of the expatriating act.

A child under the age of 18 cannot lose U.S. citizenship by naturalizing in a foreign state or by taking an oath of allegiance to a foreign state. A child under 18 can, however, lose U.S. citizenship by serving in a foreign military or by formally renouncing citizenship, but such individuals may regain their citizenship by asserting a claim of citizenship before reaching the age of eighteen years and six months.

A naturalized U.S. citizen can have his or her citizenship involuntarily revoked if a U.S. court determines that the certificate of naturalization was illegally procured, or was procured by concealment of a material fact or by willful misrepresentation (for example, if the individual concealed the fact that he served as a concentration camp guard during World War II).[291] In such cases, the individual's certificate of naturalization is canceled, effective as of the original date of the certificate; in other words, it is as if the individual were never a U.S. citizen at all.

United States immigration and visas

In general, a non-U.S. citizen who enters the United States is required to obtain a visa.[292] An immigrant visa (also known as a "green card") is issued to an individual who intends to relocate to the United States permanently. Various types of nonimmigrant visas are issued to individuals who come to the United States on a temporary basis and intend to return home after a certain period of time. The type of nonimmigrant visa issued to such individuals is dependent upon the purpose of the visit and its duration. An individual holding a nonimmigrant visa is prohibited from engaging

[290] 8 U.S.C. section 1481(b).

[291] See section 340(a) of the Immigration and Nationality Act, 8 U.S.C. section 1451(a). See also, *U.S. v. Demjanjuk*, 680 F.2d 32, *cert. denied*, 459 U.S. 1036 (1982).

[292] Under the Visa Waiver Pilot Program, nationals of most European countries are not required to obtain a visa to enter the United States if they are coming as tourists and staying a maximum of 90 days. Also, citizens of Canada, Mexico, and certain islands in close proximity to the United States do not need visas to enter the United States, although other types of travel documents may be required.

in activities that are inconsistent with the purpose of the visa (for example, an individual holding a tourist visa is not permitted to obtain employment in the United States).

Foreign business people and investors often obtain "E" visas to come into the United States. Generally, an "E" visa is initially granted for a one-year period, but it can be routinely extended for additional two-year periods. There is no overall limit on the amount of time an individual may retain an "E" visa. There are two types of "E" visas: an "E-1" visa, for "treaty traders" and an "E-2" visa, for "treaty investors."

Relinquishment of green cards

There are several ways in which a green card can be relinquished. First, an individual who wishes to terminate his or her permanent residency may simply mail his or her green card back to the INS. Second, an individual may be involuntarily deported from the United States (through a judicial or administrative proceeding), and the green card must be relinquished at that time. Third, a green card holder who leaves the United States and attempts to re-enter more than a year later may have his or her green card taken away by the INS border examiner, although the individual may appeal to an immigration judge to have the green card reinstated. A green-card holder may permanently leave the United States without relinquishing his or her green card, although such individuals would continue to be taxed as U.S. residents.[293]

Reasons for Change

The Congress was informed that a small number of very wealthy individuals each year relinquish their U.S. citizenship for the purpose of avoiding U.S. income, estate, and gift tax. By so doing, such individuals could reduce their annual U.S. income tax liability and their eventual U.S. estate tax liability.

The Congress recognized that citizens of the United States clearly have a basic right under both U.S. and international law not only to leave the United States to live elsewhere, but also to relinquish their U.S. citizenship. The Congress did not believe that the Internal Revenue Code should be used to stop U.S. citizens or residents from expatriating; however, the Congress also did not believe that the Code should provide a tax incentive for expatriating.

The Congress was concerned that prior law, which bases the application of the alternative method of taxation under sections 877, 2107 and 2501(a)(3) ("expatriation tax provisions") to former citizens on proof of a tax-avoidance purpose, could be difficult to administer. Thus, the provisions as amended generally subject certain former citizens to the expatriation tax provisions without inquiry as to their motive for losing their U.S. citizenship, but allows certain individuals to request a ruling from the Secretary of Treasury as to whether the loss of citizenship had a principal purpose of tax avoidance. The Congress believed that long-term permanent residents of the United States (i.e., green-card holders) should simi-

[293] Section 7701(b)(6)(B) provides that an individual who has obtained the status of residing permanently in the United States as an immigrant (i.e., an individual who has obtained a green card) will continue to be taxed as a lawful permanent resident of the United States until such status is revoked, or is administratively or judicially determined to have been abandoned.

larly be taxed under the expatriation tax provisions for 10 years after their U.S. residency is terminated.

The Congress was aware that taxpayers may circumvent prior-law section 877 by converting U.S. source income to foreign source income. To eliminate taxpayers' ability to escape U.S. tax by such conversions, HIPA substantially expands the scope of section 877 to apply to foreign property acquired in nonrecognition transactions. In addition, for purposes of determining the tax liability under section 877, the 10-year period is suspended with respect to any property during the period in which the individual's risk of loss with respect to such property is substantially diminished.

The Congress further believed that it was appropriate to tax amounts earned by former U.S. citizens and residents through certain controlled foreign corporations where the taxation of such amounts has been deferred during the period of U.S. citizenship or residency. Therefore, income or gains derived from stock in a foreign corporation that is more than 50-percent owned by a former citizen or resident is taxable under the provisions as amended to the extent of the earnings and profits attributable to such stock if the income or gains are realized within the 10-year period after the relinquishment of U.S. citizenship or termination of U.S. residency. This rule applies to earnings and profits attributable to such stock but only to the extent earned during the pre-expatriation period.

The Congress understood that amounts taxed under the expatriation tax provisions could be subject to double taxation (e.g., taxed by both the United States and the country of residence of the expatriate). Therefore, HIPA provides relief from double taxation in circumstances where another country also taxes the same item that is subject to tax under the expatriation tax provisions.

The Congress also was aware that certain existing U.S. income tax treaties may not permit the United States to assert its taxing jurisdiction on former citizens or long-term residents who are residents of such countries. The Congress believed that the modified expatriation tax provisions are generally consistent with the underlying principles of income tax treaties to the extent the bill provides a foreign tax credit for items that are taxed by another country, thus ceding primary taxing jurisdiction to the foreign country. To the extent that the modified expatriation provisions do conflict with the provisions of tax treaties, the Congress expected that the Treasury Department will renegotiate those treaties to eliminate any such conflicts. In the interim, the new provisions take precedence over the treaties for a period of 10 years.

In order to enhance compliance with the expatriation tax provisions, and to assist the IRS in identifying former U.S. citizens and residents who are subject to the expatriation tax provisions, HIPA imposes an information reporting obligation on former citizens and long-term residents at the time of expatriation and requires the State Department and other governmental entities to share certain information with the IRS with respect to such individuals.

Explanation of Provisions

Overview

HIPA expands and substantially strengthens in several ways the present-law provisions that subject U.S. citizens who lose their citizenship for tax avoidance purposes to special tax rules for the period of the 10 taxable years ending after such loss of citizenship (secs. 877, 2107, and 2501(a)(3)). First, HIPA extends the expatriation tax provisions to apply not only to U.S. citizens who lose their citizenship but also to certain long-term residents of the United States whose U.S. residency is terminated. Second, HIPA subjects certain individuals to the expatriation tax provisions without inquiry as to their motive for losing their U.S. citizenship or residency, but allows certain categories of citizens to show an absence of tax-avoidance motives if they request a ruling from the Secretary of the Treasury as to whether the loss of citizenship had a principal purpose of tax avoidance. Third, HIPA expands the categories of income and gains that are treated as U.S. source (and therefore subject to U.S. income tax under section 877) if earned by an individual who is subject to the expatriation tax provisions and includes provisions designed to eliminate the ability to engage in certain transactions that under current law partially or completely circumvent the 10-year reach of section 877. Further, HIPA provides relief from double taxation in circumstances where another country imposes tax on items that would be subject to U.S. tax under the expatriation tax provisions.

HIPA also contains provisions to enhance compliance with the expatriation tax provisions. HIPA imposes information reporting obligations on U.S. citizens who lose their citizenship and long-term residents whose U.S. residency is terminated at the time of expatriation. In addition, HIPA directs the Treasury Department to undertake a study regarding compliance by individuals living abroad with their U.S. tax reporting obligations and to make recommendations with respect to improving such compliance.

Individuals covered

The prior-law expatriation tax provisions applied only to certain U.S. citizens who lose their citizenship. HIPA extends these expatriation tax provisions to apply also to long-term residents of the United States whose U.S. residency is terminated. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which such termination occurs. In applying this 8-year test, an individual is not considered to be a lawful permanent resident for any year in which the individual is treated as a resident of another country under a treaty tie-breaker rule (and the individual does not elect to waive the benefits of such treaty). An individual's U.S. residency is considered to be terminated when the individual either (1) ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green-card status) or (2) is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty). Furthermore, a long-term resident may elect to use the fair

market value basis of property on the date the individual became a U.S. resident (rather than the property's historical basis) to determine the amount of gain subject to the expatriation tax provisions if the asset is sold within the 10-year period.

Under prior law, the expatriation tax provisions are applicable to a U.S. citizen who loses his or her citizenship unless such loss did not have as a principal purpose the avoidance of taxes. Under HIPA, U.S. citizens who lose their citizenship and long-term residents whose U.S. residency is terminated generally are treated as having lost such citizenship or terminated such residency with a principal purpose of the avoidance of taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of such loss or termination is greater than $100,000 (the "tax liability test"), or (2) the individual's net worth as of the date of such loss or termination is $500,000 or more (the "net worth test"). The dollar amount thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996. An individual who falls below the thresholds specified in both the tax liability test and the net worth test is subject to the expatriation tax provisions unless the individual's loss of citizenship or termination of residency did not have as a principal purpose the avoidance of tax (as under prior law in the case of U.S. citizens).

A U.S. citizen, who loses his or her citizenship and who satisfies either the tax liability test or the net worth test, is not subject to the expatriation tax provisions if such individual can demonstrate that he or she did not have a principal purpose of tax avoidance and the individual is within one of the following categories: (1) the individual was born with dual citizenship and retains only the non-U.S. citizenship; (2) the individual becomes a citizen of the country in which the individual, the individual's spouse, or one of the individual's parents, was born; (3) the individual was present in the United States for no more than 30 days during any year in the 10-year period immediately preceding the date of his or her loss of citizenship; (4) the individual relinquishes his or her citizenship before reaching age 18-1/2; or (5) any other category of individuals prescribed by Treasury regulations. In all of these situations, the individual would have been subject to tax on his or her worldwide income (as are all U.S. citizens) until the time of expatriation. In order to qualify for one of these exceptions, the former U.S. citizen must, within one year from the date of loss of citizenship, submit a ruling request for a determination by the Secretary of the Treasury as to whether such loss had as one of its principal purposes the avoidance of taxes. It is intended that a good faith submission of a ruling request be required in order to satisfy this rule. A former U.S. citizen who submits such a ruling request is entitled to challenge an adverse determination by the Secretary of the Treasury. However, a former U.S. citizen who fails to submit a timely ruling request is not eligible for these exceptions. It is expected that in making a determination as to the presence of a principal purpose of tax avoidance, the Secretary of the Treasury will take into account factors such as the substantiality of the former citizen's ties to the United States (including ownership of U.S. assets) prior to

expatriation, the retention of U.S. citizenship by the former citizen's spouse, and the extent to which the former citizen resides in a country that imposes little or no tax.

The foregoing exceptions are not available to long-term residents whose U.S. residency is terminated. However, the provision authorizes the Secretary of the Treasury to prescribe regulations to exempt categories of long-term residents from the expatriation tax provisions.

Items subject to section 877

Under section 877, an individual covered by the expatriation tax provisions is subject to tax on U.S. source income and gains for the period of the 10 taxable years ending after expatriation at the graduated rates applicable to U.S. citizens.[294] The tax under section 877 applies to U.S. source income and gains of the individual for the 10-year period, without regard to whether the property giving rise to such income or gains was acquired before or after the date the individual became subject to the expatriation tax provisions. For example, a U.S. citizen who inherits an appreciated asset immediately before losing citizenship and disposes of the asset immediately after such loss in a recognition transaction would realize little or no taxable gain on such disposition (because of the date of death fair market value basis accorded to inherited assets), but the individual would continue to be subject to tax under section 877 on the income or gain derived from any U.S. property acquired with the proceeds from such disposition.

In addition, section 877 recharacterizes as U.S. source income certain gains of individuals who are subject to the expatriation tax provisions, thereby subjecting such individuals to U.S. income tax on such gains. Under this rule, gain on the sale or exchange of stock of a U.S. corporation or debt of a U.S. person is treated as U.S. source income. In this regard, the substitution of a foreign obligor for a U.S. obligor generally is treated as a taxable exchange of the debt instrument, and therefore any gain on such exchange is subject to tax under section 877. HIPA extends this recharacterization to income and gains derived from property obtained in certain transactions on which gain or loss is not recognized under present law. An individual covered by section 877 who exchanges property that would produce U.S. source income for property that would produce foreign source income is required to recognize immediately as U.S. source income any gain on such exchange (determined as if the property had been sold for its fair market value on such date). To the extent gain is recognized under this provision, the property would be accorded the step-up in basis provided under current law. This rule requiring immediate gain recognition does not apply if the individual enters into an agreement with the Secretary of the Treasury specifying that any income or gains derived

[294] All nonresident aliens (including expatriates) are subject to U.S. income tax at graduated rates on certain types of income. Such income includes income effectively connected with a U.S. trade or business and gains from the disposition of interests in U.S. real property. For example, compensation (including deferred compensation) paid with respect to services performed in the United States is subject to such tax. Thus, a U.S. citizen who earns a stock option while employed in the United States and delays the exercise of such option until after such individual loses his or her citizenship is subject to U.S. tax on the compensation income recognized upon exercise of the stock option (even if the stock received upon the exercise is stock in a foreign corporation).

from the property received in the exchange during the 10-year period after the loss of citizenship (or termination of U.S. residency, as applicable) would be treated as U.S. source income. Such a gain recognition agreement terminates if the property transferred in the exchange is disposed of by the acquiror, and any gain that had not been recognized by reason of such agreement is recognized as U.S. source as of such date. It is expected that a gain recognition agreement would be entered into not later than the due date for the tax return for the year of the exchange. In this regard, the Secretary of the Treasury is authorized to issue regulations providing similar treatment for nonrecognition transactions that occur within 5 years immediately prior to the date of loss of citizenship (or termination of U.S. residency, as applicable).

The Secretary of Treasury is authorized to issue regulations to treat removal of tangible personal property from the United States, and other circumstances that result in a conversion of U.S. source income to foreign source income without recognition of any unrealized gain, as exchanges for purposes of computing gain subject to section 877. The taxpayer may defer the recognition of the gain if he or she enters into a gain recognition agreement as described above. For example, a former citizen who removes appreciated artwork that he or she owns from the United States could be subject to immediate tax on the appreciation under this provision unless the individual enters into a gain recognition agreement.

HIPA also provides recharacterization rules that apply if an individual who is covered by section 877 contributes property that would produce U.S. source income to a foreign corporation if (1) the individual, directly or indirectly, owns 10 percent or more (by vote) of the stock of such corporation and (2) the individual, directly, indirectly or constructively, owns more than 50 percent (by vote or by value) of the stock of such corporation. For purposes of determining indirect and constructive ownership, the rules of section 958 apply. Under these recharacterization rules, for the 10-year period the individual is treated as receiving or accruing directly the income or gains received or accrued by the foreign corporation with respect to the contributed property (or other property which has a basis determined by reference to the basis of such contributed property). Moreover, if the individual disposes of the stock of the foreign corporation, the individual is subject to U.S. tax on the gain that would have been recognized if the corporation had sold such property immediately before the disposition. If the individual disposes of less than all of his or her stock in the foreign corporation, such disposition is treated as a disposition of a pro rata share (determined based on value) of such contributed property (e.g., if the individual owns 100 shares of the foreign corporation's stock and disposes of 10 of such shares, such disposition is treated as a disposition of 10 percent of the property contributed to the foreign corporation). Regulatory authority is provided to prescribe regulations to prevent the avoidance of this rule. Information reporting will be required as necessary to carry out the purposes of this rule.

The recharacterization rules under section 877 for transfers to a foreign corporation are illustrated by the following example: Ms. A lost her U.S. citizenship on January 1, 1996, and is subject to section 877. On June 30, 1997, Ms. A transfers the stock she owns in

a U.S. corporation, USCo, to a foreign corporation, FCo, in exchange for all the stock of FCo in a transaction that qualifies for tax-free treatment under section 351. At the time of such transfer, A's basis in the stock of USCo is $100,000 and the fair market value of the stock is $150,000. Under prior law, Ms. A. generally would not be subject to U.S. tax on the $50,000 of gain realized on the exchange. Moreover, Ms. A generally would not be subject to U.S. tax on any distribution of the proceeds from a subsequent disposition of the USCo stock by FCo. Under HIPA, any income or gain on the USCo stock would be treated as received or accrued by Ms. A and not by FCo. Accordingly, if the USCo stock pays a dividend of $10,000 in 1998, Ms. A would be treated as receiving the dividend and would be subject to U.S. tax under section 877 on such dividend. Moreover, if FCo sells the USCo stock in 1998, Ms. A would be treated as recognizing the gain on such sale and would be taxable thereon under section 877. Alternatively, if Ms. A disposes of the stock of FCo in 1998 while FCo holds the USCo stock, the USCo stock would be treated as if sold by FCo immediately before Ms. A's disposition of the FCo stock; accordingly, Ms. A would be subject to U.S. tax under section 877 on the gain on the USCo stock.

HIPA also extends the recharacterization rules of section 877 to treat as U.S. source any income and gains derived from stock in a foreign corporation if the individual losing citizenship or terminating residency owns, directly or indirectly, more than 50 percent of the vote or value of the stock of the corporation on the date of such loss or termination or at any time during the 2 years preceding such date. Such income and gains are recharacterized as U.S. source only to the extent of the amount of earnings and profits attributable to such stock earned or accumulated prior to the date of loss of citizenship (or termination of residency, as applicable) and while such ownership requirement is satisfied.

The following example illustrates this rule: Mr. B lost his U.S. citizenship on July 1, 1996 and is subject to section 877. Mr. B has owned all of the stock of a foreign corporation, FCo, since its incorporation in 1991. As of FCo's December 31, 1995 year-end, FCo has accumulated earnings and profits of $500,000. FCo has earnings and profits of $100,000 for 1996 and does not have any subpart F income (as defined in sec. 952). FCo makes a $100,000 distribution to Mr. B in each of 1997 and 1998. On January 1, 1999, Mr. B disposes of all his stock of FCo and realizes $400,000 of gain. Under prior law, neither the distributions from FCo nor the gain on the disposition of the FCo stock would be subject to U.S. tax. Under HIPA, the distributions from FCo and the gain on the sale of the stock of FCo would be treated as U.S. source income and would be taxed to Mr. B under section 877, subject to the earnings and profits limitation. For this purpose, the amount of FCo's earnings and profits for 1996 is prorated based on the number of days during 1996 that Mr. B is a U.S. citizen. Thus, the amount of FCo's earnings and profits earned or accumulated before Mr. B's loss of citizenship is $550,000. Accordingly, the $100,000 distributions from FCo in 1997 and 1998 would be treated as U.S. source income taxable to Mr. B under section 877 in such years. In addition, $350,000 of the gain realized from the sale of the stock of FCo in

1999 would be treated as U.S. source income taxable to Mr. B under section 877 in that year.

Special rule for shift in risks of ownership

Section 877 applies to income and gains for the period of the 10 taxable years ending after the loss of citizenship (or termination of residency, as applicable). For purposes of applying section 877, HIPA suspends this 10-year period for gains derived from a particular property during any period in which the individual's risk of loss with respect to such property is substantially diminished. For example, Ms. C lost her citizenship on January 1, 1996 and is subject to section 877. On that date Ms. C owns 10,000 shares of stock of a U.S. corporation, USCo, with a value of $1 million. On the same date Ms. C enters into an equity swap with respect to such USCo stock with a 5-year term. Under the transaction, Ms. C will transfer to the counter-party an amount equal to the dividends on the USCo stock and any increase in the value of the USCo stock for the 5-year period. The counter-party will transfer to Ms. C an amount equal to a market rate of interest on $1 million and any decrease in the value of the USCo stock for the same period. Ms. C's risk of loss with respect to the USCo stock is substantially diminished during the 5-year period in which the equity swap is in effect, and therefore, under HIPA, the 10-year period under section 877 is suspended during such period. Accordingly, if Ms. C sells her USCo stock for a gain on January 1, 2010, such gain would be treated as U.S. source income taxable to Ms. C under section 877. Such gain would not be subject to U.S. tax under prior law.

Double tax relief

In order to avoid the double taxation of individuals subject to the expatriation tax provisions, HIPA provides a credit against the U.S. tax imposed under such provisions for any foreign income, gift, estate or similar taxes paid with respect to the items subject to such taxation. This credit is available only against the tax imposed solely as a result of the expatriation tax provisions, and is not available to be used to offset any other U.S. tax liability. For example, Mr. D lost his citizenship on January 1, 1996 and is subject to section 877. Mr. D becomes a resident of Country X. During 1996, Mr. D recognizes a $100,000 gain upon the sale of stock a U.S. corporation, USCo. Country X imposes $20,000 tax on this capital gain. But for the double tax relief provision, Mr. D would be subject to tax of $28,000 on this gain under section 877. However, Mr. D 's U.S. tax under section 877 would be reduced by the $20,000 of foreign tax paid, and Mr. D 's resulting U.S. tax on this gain would be $8,000.

Effect on tax treaties

While it is believed that the expatriation tax provisions, as amended by HIPA, are generally consistent with the underlying principles of income tax treaties to the extent the provision provides a foreign tax credit for items taxed by another country, it is intended that the purpose of the expatriation tax provisions, as amended, not be defeated by any treaty provision. The Treasury Department is expected to review all outstanding treaties to deter-

mine whether the expatriation tax provisions, as revised, potentially conflict with treaty provisions and to eliminate any such potential conflicts through renegotiation of the affected treaties as necessary. Beginning on the tenth anniversary of the enactment of the provision, any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as revised.

Required information reporting and sharing

Under HIPA, a U.S. citizen who loses his or her citizenship is required to provide a statement to the State Department (or other designated government entity) which includes the individual's social security number, forwarding foreign address, new country of residence and citizenship, a balance sheet in the case of individuals with a net worth of at least $500,000, and such other information as the Secretary may prescribe.[295] The entity to which such statement is to be provided is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. A long-term resident whose U.S. residency is terminated is required to attach a similar statement to his or her U.S. income tax return for the year of such termination. An individual's failure to provide the required statement results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year, or (2) $1,000.

HIPA requires the State Department to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, HIPA requires the agency administering the immigration laws to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned.

Further, HIPA requires the Secretary of the Treasury to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or whose names or CLNs it receives under the foregoing information-sharing provisions.

Treasury report on tax compliance by U.S. citizens and residents living abroad

The Treasury Department is directed to undertake a study on the tax compliance of U.S. citizens and green-card holders residing outside the United States and to make recommendations regarding the improvement of such compliance. The findings of such study and such recommendations are required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days after August 21, 1996 (the date of enactment of HIPA).

During the course of the 1995 Joint Committee on Taxation staff study on expatriation (see Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation*

[295] A technical correction will be required to redesignate the section containing the information reporting rules as section 6039G.

(JCS-17-95), June 1, 1995), a specific issue was identified regarding the difficulty in determining when a U.S. citizen has committed an expatriating act with the requisite intent, and thus no longer has the obligation to continue to pay U.S. taxes on his or her worldwide income due to the fact that the individual is no longer a U.S. citizen. Neither the Immigration and Nationality Act nor any other Federal law requires an individual to request a CLN within a specified amount of time after an expatriating act has been committed, even though the expatriating act terminates the status of the individual as a U.S. citizen for all purposes, including the status of being subject to U.S. tax on worldwide income. Accordingly, it is anticipated that the Treasury report, in evaluating whether improved coordination between executive branch agencies could improve compliance with the requirements of the Internal Revenue Code, will review the process through which the State Department determines when citizenship has been lost, and make recommendations regarding changes to such process to recognize the importance of such date for tax purposes. In particular, it is anticipated that the Treasury Department will explore ways of working with the State Department to insure that the State Department will not issue a CLN confirming the commission of an expatriating act with the requisite intent necessary to terminate citizenship in the absence of adequate evidence of both the occurrence of the expatriating act (e.g., the joining of a foreign army) and the existence of the requisite intent.

Effective Date

The expatriation tax provisions as modified by HIPA generally apply to any individual who loses U.S. citizenship, and any long-term residents whose U.S. residency is terminated, on or after February 6, 1995. For citizens, the determination of the date of loss of citizenship remains the same as under prior law (i.e., the date of loss of citizenship is the date of the expatriating act). In the case of any former U.S. citizen, a request for a ruling that such individual did not have the avoidance of U.S. tax as a principal purpose for such individual's loss of citizenship will be due not earlier than 90 days after August 21, 1996 (the date of enactment of HIPA). Similarly, the required information statements will not be due earlier than 90 days after August 21, 1996. The Internal Revenue Service has announced that it intends to issue detailed guidance on with respect to the ruling request and information reporting rules. Notice 96-60, 1996-49 I.R.B. 7. The Notice provides that ruling requests and information statements will not be due earlier than 60 days after the issuance of such guidance.

A special transition rule applies to individuals who committed an expatriating act within one year prior to February 6, 1995, but had not applied for a CLN as of such date. Such an individual is subject to the expatriation tax provisions (as modified by HIPA) as of the date of application for the CLN, but is *not* retroactively liable for U.S. income taxes on his or her worldwide income.

The special transition rule is illustrated by the following example. Mr. E joined a foreign army on October 1, 1994 with the intent to relinquish his U.S. citizenship, but Mr. E does not apply for a CLN until October 1, 1995. Mr. E would be subject to the expatria-

tion tax provisions (as amended) for the 10-year period beginning on October 1, 1995. Moreover, if Mr. E falls within one of the specified categories (i.e., Mr. E is age 18 when he joins the foreign army), in order to qualify for the exception provided for such individuals, Mr. E would be required to submit his ruling request within the requisite period (i.e., not earlier than 60 days after the issuance of guidance with respect to the ruling request requirement). Mr. E would not, however, be liable for U.S. income taxes on his worldwide income for any period after October 1, 1994.

Revenue Effect

The provision is estimated the increase Federal fiscal year budget receipts by $52 million in 1996, $97 million in 1997, $146 million in 1998, $199 million in 1999, $254 million in 2000, $289 million in 2001, $304 million in 2002, $319 million in 2003, $335 million in 2004, $351 million in 2005, and $368 million in 2006.

C. Repeal of Financial Institution Transition Rule to Interest Allocation Rules (sec. 521 of HIPA[296] and sec. 864 of the Code)

Present and Prior Law

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

Reasons for Change

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

Explanation of Provision

HIPA repeals section 1215(c)(5) of the Tax Reform Act of 1986.

Effective Date

The provision generally applies to taxable years beginning after December 31, 1995. A special rule applies to the first taxable year beginning after December 31, 1995. Under the special rule, the pre-effective date portion of the taxpayer's interest expense is to be allocated and apportioned without regard to the repeal of the targeted rule. For this purpose, the pre-effective date portion of the

[296] A similar provision was included in the Senate version of the Small Business Act.

interest expense is 233/366 of the total interest expense for such taxable year (i.e., the fraction of such total interest expense based on the ratio of the number of days during such taxable year before the August 21, 1996 enactment date to the total number of days during such taxable year). These computations will not require a closing of a taxpayer's books and records and it is intended that an administratively simple approach be used in applying this rule.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $10 million in 1996, $73 million in 1997, $107 million in 1998, $123 million in 1999, $141 million in 2000, $163 million in 2001, $187 million in 2002, $201 million in 2003, $215 million in 2004, $228 million in 2005, and $242 million in 2006.

PART SIX:

REVENUE PROVISIONS OF THE PERSONAL RESPONSIBILITY AND WORK OPPORTUNITY RECONCILIATION ACT OF 1996 (H.R. 3734) [297]

A. Rules Relating to Denial of Earned Income Credit on Basis of Disqualified Income (sec. 909 of the Personal Responsibility Act and sec. 32 of the Code)

Present and Prior Law

For taxable years beginning after December 31, 1995, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,350. This threshold is not indexed. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt);
(2) dividends; and
(3) net rent and royalty income (if greater than zero).

Reasons for Change

The Congress believes that individuals with substantial assets could use proceeds from the sale of those assets in place of the earned income credit to support consumption in times of low income. Transfer programs such as AFDC, food stamps, and Medicaid have asset tests for determining eligibility. Such programs also have caseworkers available to make determinations about the assets owned by a potential claimant. In the case of the earned income credit, the IRS does not have caseworkers to assess the balance sheets of millions of taxpayers, and it does not currently have information on most taxpayer's asset-holdings. Therefore, in order to apply a proxy for an asset-based test, the recently enacted disqualified income test concentrates on the returns generated by those assets. Interest, dividend, and net rental and royalty income represent flows of income from assets that represent wealth of the taxpayer. The Congress believes that net capital gains and other passive income represent other flows of income from assets that could be liquidated and used to support current consumption. The Congress also believes that this threshold should be set in inflation-adjusted dollars, so it is indexing the threshold for inflation.

[297] Public Law 104-193; signed on August 22, 1996. H.R. 3734 was reported by the House Committee on the Budget on June 27, 1996 (H. Rept. 104-651), and was passed by the House, as amended, on July 18, 1996. The bill was passed by the Senate on July 23, 1996. The conference report was filed on July 30, 1996 (H. Rept. 104-725), and was approved by the House on July 31, 1996 and by the Senate on August 1, 1996.

Explanation of Provision

For purposes of the disqualified income test for the earned income credit, the following items are added to the definition of disqualified income: capital gain net income and net passive income (if greater than zero) that is not self-employment income.

The threshold above which an individual is not eligible for the credit is reduced from $2,350 to $2,200, and the threshold is indexed for inflation after 1996.[298]

Effective Date

The provision generally is effective for taxable years beginning after December 31, 1995. For individuals who, as of June 26, 1996, had made an election to receive the current-year credit on an advance basis, the provision is effective for taxable years beginning after December 31, 1996.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $196 million in 1997, $195 million in 1998, $178 million in 1999, $169 million in 2000, $175 million in 2001, $185 million in 2002, $180 million in 2003, $177 million in 2004, $168 million in 2005, and $160 million in 2006.[299]

B. Definition of Adjusted Gross Income Used for Phasing Out the Earned Income Credit (sec. 910 of the Personal Responsibility Act and sec. 32 of the Code)

Present and Prior Law

For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum earned income credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

Reasons for Change

The Congress believed it can improve the targeting of the credit by expanding the definition of income used in phasing out the credit. The Congress believed that the definition of AGI used currently in phasing out the credit is too narrow; denying certain losses reported on Schedules C, D, E, and F would help conform the income definition used for the phaseout closely to a more accurate measure of economic well being. To the extent such individual's well being

[298] The Self-Employed Person's Health Care Reduction Extension Act of 1995 (P.L. 104-7, April 11, 1995) also modified the operation of the earned income credit. This provision specifically amended that Act. See the discussion in Part One of this pamphlet.

[299] Included in this estimate are decreases in EIC outlays of $170 million in fiscal year 1997, $168 million in fiscal year 1998, $151 million in fiscal year 1999, $146 million in fiscal year 2000, $162 million in fiscal year 2001, $160 million in fiscal year 2002, $156 million in fiscal year 2003, $151 million in fiscal year 2004, $145 million in fiscal year 2005, and $136 million in fiscal year 2006.

exceeds certain levels, the Congress believed that eligibility for the credit should be phased out.

Explanation of Provision

The Personal Responsibility Act modifies the definition of AGI used for phasing out the earned income credit by disregarding certain losses.

The losses disregarded are:

(1) net capital losses (if greater than zero);

(2) net losses from trusts and estates;

(3) net losses from nonbusiness rents and royalties; and

(4) 50 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

For purposes of item (4), above, amounts attributable to a business that consists of the performance of services by the taxpayer as an employee are not taken into account.[300]

Effective Date

The provision generally is effective for taxable years beginning after December 31, 1995. For individuals who, as of June 26, 1996, had made an election to receive the current-year credit on an advance basis, the provision is effective for taxable years beginning after December 31, 1996.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $113 million in 1997, $125 million in 1998, $133 million in 1999, $141 million in 2000, $154 million in 2001, $166 million in 2002, $173 million in 2003, $183 million in 2004, $193 million in 2005, and $204 million in 2006.[301]

C. Deny Earned Income Credit to Individuals Not Authorized to be Employed in the United States (sec. 451 of the Personal Responsibility Act and sec. 32 of the Code)

Present and Prior Law

In general

Certain eligible low-income workers are entitled to claim a refundable credit on their income tax return. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the individual's[302] earned income up to an earned income amount. The maximum

[300] The Self-Employed Person's Health Care Reduction Extension Act of 1995 (P. L. 104-7, April 11, 1995) also modified the operation of the earned income credit. See discussion in Part One of this pamphlet.

[301] Included in this estimate are decreases in EIC outlays of $98 million in fiscal year 1997, $106 million in fiscal year 1998, $112 million in fiscal year 1999, $120 million in fiscal year 2000, $129 million in fiscal year 2001, $138 million in fiscal year 2002, $144 million in fiscal year 2003, $152 million in fiscal year 2004, $160 million in fiscal year 2005, and $168 million in fiscal year 2006.

[302] In the case of a married individual who files a joint return with his or her spouse, the income for purposes of these tests is the combined income of the couple.

amount of the credit is the product of the credit rate and the earned income amount. For individuals with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1996, the parameters are given in the following table:

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	$8,890	$6,330	$4,220
Maximum credit	$3,556	$2,152	$323
Phaseout begins	$11,610	$11,610	$5,280
Phaseout rate (percent)	21.0	15.98	7.65
Phaseout ends	$28,495	$25,078	$9,500

For years after 1996, the credit rates and the phaseout rates will be the same as in the preceding table. The earned income amount and the beginning of the phaseout range are indexed for inflation; because the end of the phaseout range depends on those amounts as well as the phaseout rate and the credit rate, the end of the phaseout range will also increase if there is inflation.

In order to claim the credit, an individual must either have a qualifying child or meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the credit without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

To satisfy the identification test, individuals must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1996, individuals must provide a taxpayer identification number (TIN) for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, individuals must provide TINs for all qualifying children, regardless of their age. An individual's TIN is generally that individual's social security number.

An individual with qualifying children may elect to receive the credit on an advance basis by furnishing an advance payment certificate to his or her employer. For such an individual, the employer makes an advance payment of the credit at the time wages are paid. The amount of advance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to an individual with one qualifying child.

Mathematical or clerical errors

The Internal Revenue Service may summarily assess additional tax due as a result of a mathematical or clerical error without

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sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. The request for abatement of the assessment is the only procedure a taxpayer may use prior to paying the assessed amount in order to contest an assessment arising out of a mathematical or clerical error. Once the assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Reasons for Change

The Congress did not believe that individuals who are not authorized to work in the United States should be able to claim the credit. To enforce the requirement that credit claimants and their qualifying children have proper Social Security numbers (indicating that they have been authorized to work legally in the U.S.) and to insure that credit claimants have paid self-employment taxes on any self employment income use used to qualify for the credit, the Congress believed that the IRS should be able to use the streamlined procedures it currently uses for mathematical or clerical errors.

Explanation of Provision

Individuals are not eligible for the credit if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number is defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits).[303]

If an individual fails to provide a correct taxpayer identification number, such omission will be treated as a mathematical or clerical error. If an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment tax on such net earnings, the failure will be treated as a mathematical or clerical error for purposes of the amount of credit allowed.[304]

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[303] A technical correction may be needed to accommodate certain taxpayers with religious objection to participation in the Social Security Act programs (parallel to section 1402(g) of the Code).

[304] The Self-Employed Person's Health Care Reduction Extension Act of 1995 (P. L. 104-7, April 11, 1995) also modified the operation of the earned income credit. See discussion in Part One of this pamphlet.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $252 million in 1997, $261 million in 1998, $265 million in 1999, $272 million in 2000, $276 million in 2001, $282 million in 2002, $289 million in 2003, $295 million in 2004, $302 million in 2005, and $309 million in 2006.[305]

[305] Included in this estimate are decreases in EIC outlays of $224 million in fiscal year 1997, $232 million in fiscal year 1998, $236 million in fiscal year 1999, $242 million in fiscal year 2000, $245 million in fiscal year 2001, $251 million in fiscal year 2002, $257 million in fiscal year 2003, $263 million in fiscal year 2004, $269 million in fiscal year 2005, and $276 million in fiscal year 2006.

PART SEVEN:

OTHER TAX-RELATED PROVISION

1. Tax Treatment of Special Assessments for Savings Association Insurance Fund (H.R. 3610)[306] (sec. 2711 of the Act and secs. 162 and 172(f) of the Code)

Prior Law and Background

Section 2702 of Title II ("Economic Growth and Regulatory Paperwork Reduction Act of 1996") in the 1997 Continuing Appropriations Bill (H.R. 3610, P.L. 104-208) requires thrift institutions to pay certain assessments to the Saving Association Insurance Fund ("SAIF"). The SAIF is the insurance fund for deposits in thrift institutions. The amount of the assessments generally is the amount necessary to ensure that the SAIF has reserves of $1.25 for each $100 of insured deposits.

In general, under section 162 of the Code, a taxpayer is allowed to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business during the taxable year. However, under section 263 of the Code, amounts that give rise to a permanent improvement or betterment must be capitalized rather than deducted currently. Whether an expenditure is deductible under section 162 or must be capitalized under section 263 is often a matter of dispute between the IRS and taxpayers, and has been the subject of significant litigation. Most recently, in *INDOPCO v. Commissioner*, 503 U.S. 79 (1992), the U.S. Supreme Court noted that the capitalization of expenditures is the norm and that a current "income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."[307] In *INDOPCO*, the Court distinguished its prior decision in *Lincoln Savings v. Commissioner*, 403 U.S. 345 (1971), (relating to additional premiums paid by a thrift institution to the Federal Savings and Loan Insurance Corporation) to hold that it is not necessary for an expenditure to give rise to the creation of a separate and distinct asset before such expenditure is capitalized. Rather, the Court held that "although the presence of an incidental future benefit may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expend-

[306] P.L. 104-208; signed on September 30, 1996.
H. R. 3610, the fiscal 1997 appropriations bill for the Department of Defense, was reported by the House Committee on Appropriations on June 11, 1996 (H. Rept. 104-617). The bill was passed by the House, as amended, on June 13, 1996. H.R. 3610 was passed by the Senate, as amended, on July 18, 1996. The conference report was filed on September 28, 1996 (H. Rept. 104-863), including continuing appropriations for fiscal 1997 from H.R. 4278, and was approved by the House on September 28, 1996 and by the Senate on September 30, 1996. The tax-related provisions in section 2711 of the bill was added in conference.

[307] *INDOPCO*, citing *Interstate Transit Lines v. Comm.*, 319 U.S. 590, 593 (1943); *Deputy v. DuPont*, 308 U.S. 488, 493 (1940); and *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

iture is incurred is important in determining whether the appropriate tax treatment is immediate deduction or capitalization." In *INDOPCO*, the Supreme Court found that the record supported the lower courts' findings that the investment banking fees in question produced significant benefits extending beyond the tax year in which they were incurred so as to warrant capitalization.

The proper scope and application of the *INDOPCO* decision to various expenditures often is unclear. It is understood that it was the view of the Department of the Treasury that special assessment payments to the SAIF that had been proposed in previous legislation in the 104th Congress would have been deductible under prior law.[308]

Reason for Change

The Congress wished to clarify the Federal income tax treatment of the special assessments paid to the SAIF.

Explanation of Provision

The provision clarifies that (1) the assessments paid pursuant to section 2702 of H.R. 3610 are currently deductible under Code section 162 and (2) Code section 172(f) does not apply to any portion of a net operating loss attributable to the deductions allowed for such assessments.[309]

Effective Date

The provision is effective upon enactment.

Revenue Effect

The provision is estimated to have no effect upon Federal budget receipts.

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[308] See, e.g., the testimony of Cynthia G. Beerbower, Deputy Assistant Secretary (Tax Policy) Department of the Treasury, on H.R. 2494 before the House Committee on Ways and Means, October 26, 1995.

[309] Under present law, net operating losses can be carried back three years. Code section 172(f) allows "specified liability losses" to be carried back ten years. Specified liability losses include amounts allowable as deductions with respect to product liabilities or with respect to certain acts (or failures to act) that occurred more than three years ago.

APPENDIX:

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
PART ONE: SELF-EMPLOYED HEALTH INSURANCE DEDUCTION; REPEAL OF SECTION 1071 (H.R. 831)														
A. Extend self-employed health deduction: 25% for 1994 and 30% thereafter (sec. 1)	tyba 12/31/93	−514	−482	−527	−587	−649	−708	−769	−834	−901	−972	−1,044	−1,118	−9,105
B. Repeal section 1071 (FCC tax certificate program with transition) (sec. 2)	1/17/95	303	379	135	135	170	201	232	263	293	322	355	355	3,143
C. Modify section 1033 for corporations with transition rule for microwave relocation previously entitled to section 1071 (non-recognition of gain on involuntary conversions not to apply to acquisitions from related persons) (sec. 3)	2/6/95	5	9	23	33	47	67	87	111	137	165	189	202	1,075
D. Deny earned income tax credit to individuals with interest, dividends, tax-exempt interest income, and net rental and royalty income over $2,350 (the threshold is not indexed for inflation) (sec. 4) (1)	1/1/96	....	22	436	487	521	556	612	655	700	748	800	852	6,389
E. Extension of rule for certain group health plans (sec. 5)	DOE	−42	−11	....	....	....	....	....	....	....	....	....	....	−53
Subtotal: H.R. 831		**−248**	**−83**	**67**	**68**	**89**	**116**	**162**	**195**	**229**	**263**	**300**	**291**	**1,449**

Provision	Effective												
PART TWO: TAX BENEFITS FOR INDIVIDUALS PERFORMING SERVICES IN CERTAIN HAZARDOUS DUTY AREAS (H.R. 2778)													
1. Extend certain tax benefits to Armed Forces personnel serving in the former Yugoslavia; raise the monthly exclusion from income for combat pay for officers from $500/month to the highest pay level for enlisted personnel; and conform wage withholding rule to income exclusion rule for officers (sec. 1)	11/21/95	−38	−45	(3)									−83
2. Extend IRS user fees through 9/30/03 (sec. 2) (2)	10/1/00						35	35	35				105
Subtotal: H.R. 2778		**−38**	**−45**	**(3)**			**35**	**35**	**35**				**22**
PART THREE: TAXPAYER BILL OF RIGHTS 2 (H.R. 2337)													
A. Taxpayer Bill of Rights 2 Provisions													
1. Taxpayer advocate:													
a. Establishment of position of Taxpayer Advocate (sec. 101)	DOE						No Revenue Effect						
b. Expansion of authority to issue Taxpayer Assistance Orders (sec. 102)	DOE						No Revenue Effect						
2. Modifications to installment agreement provisions:													
a. Notification of reasons for termination of installment agreements (sec. 201)	6 ma DOE						No Revenue Effect						
b. Administrative review of termination of installment agreements (sec. 202)	1/1/97						No Revenue Effect						
3. Abatement of interest and penalties:													
a. Expansion of authority to abate interest (sec. 301)	DOE	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(5)
b. Review of IRS failure to abate interest (sec. 302)	DOE	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(4)	(5)
c. Extension of interest-free period for payment of tax (sec. 303)	6/30/96	−2	−7	−8	−8	−8	−9	−9	−9	−10	−10	−11	−91

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
d. Abate penalty for failure to deposit payroll tax (sec. 304):														
i. On-budget	DOE	....	−23	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−33
ii. Off-budget (not reflected in subtotal)	DOE	....	−38	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−48
4. Joint returns:														
a. Studies of joint return-related issues (sec. 401)	DOE	No Revenue Effect												
b. Joint return may be made after separate returns without full payment of tax (sec. 402)	DOE	....	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
c. Disclosure of collection activities (sec. 403)	DOE	No Revenue Effect												
5. Collection activities:														
a. Modifications to lien and levy provisions:														
i. Withdraw notice of lien (sec. 501(a))	1/1/97	No Revenue Effect												
ii. Return levied property (sec. 501(b))	1/1/97	No Revenue Effect												
iii. increase levy exemption (sec. 502)	1/1/97	....	....	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
b. Offers-in-compromise (sec. 503)	DOE	....	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
6. Information returns:														
a. Civil damages for fraudulent filing of information return (sec. 601)	DOE	No Revenue Effect												
b. Requirement to conduct reasonable investigations (sec. 602)	DOE	....	−3	−6	−6	−6	−7	−8	−8	−8	−8	−9	−9	−78
7. Awarding of costs and certain fees:														
a. United States must establish that position in proceeding was substantially justified (sec. 701)	DOE	....	−2	−2	−2	−3	−3	−3	−3	−3	−3	−3	−3	−30
b. Increased limit on attorney fees (sec. 702)	DOE	....	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−11
c. Failure to agree to extension not taken into account (sec. 703)	DOE	No Revenue Effect												

Provision	Effective												
d. Award of litigation costs permitted in declaratory judgment proceedings (sec. 704)	DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
8. Modification to recovery of civil damages for unauthorized collection actions:													
a. Increase in limit on recovery of civil damages (sec. 801)	DOE	−3	−3	−3	−3	−3	−3	−3	−3	−3	−3	−3	−33
b. Court discretion to reduce award for litigation costs (sec. 802)	DOE	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−11
9. Modification to penalty for failure to collect and pay over tax:													
a. Preliminary notice requirement (sec. 901)	6/30/96	No Revenue Effect											
b. Disclosure of certain information where more than one person liable for penalty (sec. 902)	DOE	No Revenue Effect											
c. Right of contribution where more than one person liable for penalty (sec. 903)	DOE	No Revenue Effect											
d. Volunteer board members of tax-exempt organizations exempt from penalty (sec. 904)	DOE	No Revenue Effect											
10. Modification of rules relating to summonses:													
a. Enrolled agents included as third-party recordkeepers (sec. 1001)	DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
b. Safeguards relating to designated summonses; annual report to Congress on designated summonses (secs. 1002–1003)	DOE	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[5]
11. Relief from retroactive application of Treasury Department regulations with 18 month safe-harbor (sec. 1101)	DOE		−1	−4	−4	−4	−4	−4	−5	−5	−5	−5	−41
12. Miscellaneous provisions:													
a. Phone number of person providing payee statements (sec. 1201)	1/1/97	No Revenue Effect											
b. Required notice of certain payments (sec. 1202)	DOE	No Revenue Effect											
c. Unauthorized enticement of information disclosure (sec. 1203)	DOE	No Revenue Effect											
d. Annual reminders to taxpayers with delinquent accounts (sec. 1204)	1/1/97		[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[7]
e. Reinstatement of authority for undercover operations through 12/31/00 (sec. 1205)	DOE	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[8]

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
f. Disclosure of returns concerning cash transactions (sec. 1206)	DOE	No Revenue Effect												
g. Disclosure of returns and return information to designee of taxpayer (sec. 1207)	DOE	No Revenue Effect												
h. Study of netting of interest on overpayments and liabilities (sec. 1208)	DOE	No Revenue Effect												
i. Expenses of detection of underpayments and fraud (sec. 1209)	6 ma DOE	Negligible Revenue Effect												
j. Use of private delivery services for "timely-mailing-as-timely-filing" rule (sec. 1210)	DOE	No Revenue Effect												
k. Reports on misconduct by IRS employees (sec. 1211)	DOE	No Revenue Effect												
B. Revenue Offsets														
1. Apply failure to pay penalty to substitute returns (sec. 1301)	rda DOE	....	1	3	29	30	32	33	35	37	38	40	42	320
2. Intermediate sanctions for certain tax-exempt organizations (secs. 1311–1314)	9/14/95 1/1/96	....	4	4	4	5	5	5	6	6	6	7	7	59
Subtotal: H.R. 2337		....	−30	−15	7	8	9	8	11	12	12	14	15	51

Provision	Effective												
PART FOUR: REVENUE PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 (H.R. 3448)													
I. Small Business and Other Tax Provisions													
A. Small Business Provisions													
1. Increase in expensing limitation for small businesses to $18,000 for 1997, $18,500 for 1998, $19,000 for 1999, $20,000 for 2000, $24,000 for 2001, $24,000 for 2002, $25,000 for 2003 and thereafter (sec. 1111) [9]	tyba 12/31/96		−67	−180	−261	−331	−763	−938	−786	−646	−439	−265	−4,676
2. FICA tip credit (sec. 1112):													
a. Provided for off-premises employees	1/1/97		−6	−14	−15	−16	−17	−18	−18	−19	−20	−21	−165
b. Clarification of effective date	[10]	Negligible Revenue Effect											
3. Treatment of storage of product samples (sec. 1113)	tyba 12/31/95	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	−2
4. Provide that certain charitable risk pools would qualify as charitable organizations under section 501(c)(3) (sec. 1114)	tyba DOE		[11]	−1	−1	−1	−1	−2	−2	−2	−3	−3	−16
5. Treatment of certain dues paid to agricultural or horticultural organizations (sec. 1115)	tyba 12/31/86	Negligible Revenue Effect											
6. Clarify exemption from FICA taxes for certain fishermen and provide that exemption applies even if crew member receives de minimis amount of cash payments (sec. 1116(a))	[12]	−1	−10	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	−13
7. Require purchasers of fish in excess of $600 in cash to provide information reports (sec. 1116(b))	12/31/97			5	9	10	10	11	11	11	12	12	91
8. Change related-party and maximum size requirements for first-time farmer industrial development bonds (sec. 1117)	bia DOE		−1	−6	−12	−17	−21	−26	−30	−34	−37	−40	−224

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
9. Clarify that newspaper carriers and distributors are independent contractors (sec. 1118)	spa 12/31/95	Negligible Revenue Effect												
10. Provide involuntary conversion treatment for Presidentally declared disaster areas (sec. 1119)	DDA 12/31/94		−6	−14	−10	−10	−10	−10	−10	−10	−10	−10	−10	−110
11. Provide 15-year depreciation for gas station/convenience stores (sec. 1120)	ppiso/a/b DOE		−7	−24	−37	−45	−50	−53	−53	−55	−61	−42	−25	−452
12. Leasehold improvements provision (sec. 1121)	lida 6/12/96		−12	−22	−19	−16	−13	−11	−7	−4	−2	1	4	−101
13. Worker classification (sec. 1122):														
a. Clarification of section 530 safe harbor	spa 12/31/96			[11]	[11]	[11]	[11]	[11]	−1	−1	−1	−1	−1	−6
b. Provide that if the taxpayer reclassifies independent contractors as employees, this change does not alter the application of the safe harbor for prior periods	pa 12/31/96			[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[5]
c. Clarify "substantially similar position"	pa 12/31/96	Negligible Revenue Effect												
14. Allow certain teaching hospitals to provide tax-free housing to medical faculty (sec. 1123)	tyba 12/31/95		[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[13]

Provision	Effective												
B. Extension of Certain Expiring Provisions													
1. Extend the work opportunity tax credit, with modifications through 9/30/97 (sec. 1201) [14]	10/1/96		−116	−141	−82	−32	−12	−2					−385
2. Employee-provided educational assistance; extend for graduate education through 6/30/96; undergraduate education sunset 5/31/97 (sec. 1202)	1/1/95	−68	−934	−103									−1,105
3. Permanent extension of FUTA exemption for alien agricultural workers (sec. 1203) [2]	1/1/95	−5	−3	−3	−3	−3	−3	−3	−3	−3	−3	−3	−35
4. R&E credit, with modifications through 5/31/97 (sec. 1204)	7/1/96	−101	−331	−872	−208	−148	−77	−17					−1,754
5. Orphan drug tax credit through 5/31/97 with section 39 benefits (sec. 1205)	7/1/96	−6	−16	−1	−1	−1	−1	(11)	(11)	(11)	(11)	(11)	−26
6. Contribution of appreciated stock to private foundations through 5/31/97 (sec. 1206)	7/1/96	−14	−104	−10	−4								−132
7. Extend section 29 binding contract date to 12/31/96 and placed-in-service date to 6/30/98 for biomass and coal (sec. 1207)	DOE		−8	−34	−60	−69	−65	−57	−55	−56	−58	−59	−522
8. Suspend excise tax on recreational motorboat diesel through 12/31/97 (sec. 1208)	DOE + 7 days	−4	−34	−9									−47
C. Provisions Relating to S Corporations													
1. Increase number of eligible shareholders (sec. 1301)	tyba 12/31/96		−5	−14	−16	−20	−22	−25	−28	−31	−35	−39	−235
2. Permit certain trusts to hold stock in S corporations (sec. 1302)	tyba 12/31/96		−2	−2	−2	−2	−2	−2	−2	−3	−3	−3	−23
3. Extend holding period for certain trusts (sec. 1303)	tyba 12/31/96		(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(15)
4. Financial institutions permitted to hold safe-harbor debt (sec. 1304)	tyba 12/31/96		(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	−1
5. Authority to validate cetain invalid elections (sec. 1305)	tyba 12/31/82		(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	−1

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
6. Allow interim closing of the books (sec. 1306)	tyba 12/31/96	Negligible Revenue Effect												
7. Expand post-termination period and amend subchapter S audit procedures (sec. 1307)	tyba 12/31/96			(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	−1
8. S corporations permitted to hold S or C subsidiaries (sec. 1308)	tyba 12/31/96			−5	−9	−11	−13	−15	−17	−20	−23	−26	−29	−168
9. Treatment of distributions during loss years (sec. 1309)	tyba 12/31/96			(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	−1
10. Treatment of S corporations as shareholders in C corporations (sec. 1310)	tyba 12/31/96			(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(15)
11. Elimination of certain earnings and profits of S corporations (sec. 1311)	tyba 12/31/96			(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(15)
12. Treatment of certain losses carried over under at-risk rules (sec. 1312)	tyba 12/31/96			(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(15)
13. Adjustments to basis of inherited S stock (sec. 1313)	dda DOE			(6)	(6)	(6)	(6)	(6)	(6)	(6)	(6)	(6)	(6)	(6)
14. Treatment of certain real estate held by an S corporation (sec. 1314)	tyba 12/31/96			−1	−1	−2	−2	−2	−2	−2	−2	−2	−2	−18
15. Treat financial institutions that do not use the reserve method as eligible corporations (sec. 1315)	tyba 12/31/96			−1	−3	−5	−6	−8	−10	−12	−14	−15	−16	−90

Provision	Effective											
16. Permit tax-exempts to be subchapter S shareholders with UBTI inclusion and ESOP benefit restriction (sec. 1316)	tyba 12/31/97	....	−3	−9	−11	−13	−15	−17	−19	−21	−23	−131
17. Transition rule for elections after termination (sec. 1317(b))	tyba 12/31/96	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(5)	(15)
18. Interaction of subchapter S changes except for ESOP and financial institution proposals		−3	−26	−32	−37	−38	−39	−40	−40	−40	−40	−335
II. Pension Simplification Provisions												
A. Simplified Distribution Rules (secs. 1401–1404)												
1. Repeal of 5-year income averaging for lump-sum distributions	tyba 12/31/99	74	77	108	78	70	44	17	15	....	....	483
2. Repeal of $5,000 exclusion of employees' death benefits	dda DOE	28	49	52	54	55	55	56	57	57	58	521
3. Simplified method for taxing annuity distributions under certain employer plans	asda 90 da DOE	22	28	28	29	29	29	30	30	31	31	287
4. Minimum required distributions	yba 12/31/96	−1	−4	−4	−4	−4	−4	−4	−4	−4	−4	−37
B. Increased Access to Retirement Savings Plans												
1. Establish SIMPLE pension plan (secs. 1421–1422)	yba 12/31/96	−50	−76	−79	−81	−84	−87	−91	−94	−97	−101	−840
2. Tax-exempt organizations eligible under section 401(k) (sec. 1426)	yba 12/31/96	−8	−22	−24	−25	−26	−28	−29	−30	−31	−31	−254
3. Increase availability of spousal IRAs (sec. 1427)	yba 12/31/96	−57	−168	−184	−195	−206	−219	−233	−248	−264	−281	−2,055
C. Nondiscrimination Provisions												
1. Simplified definition of highly compensated employees; employers can elect whether or not to apply a top 20% test (sec. 1431(a)) (16)	yba 12/31/96	(13)	(13)	Considered in Other Provisions								(17)

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
2. Repeal of family aggregation rules (sec. 1431(b)) [16]	yba 12/31/96			[3]	[3]			Considered in Other Provisions						[3]
3. Modification of additional participation requirements (sec. 1432)	yba 12/31/96							Negligible Revenue Effect						
4. Safe-harbor nondiscrimination rules for qualified cash or deferred arrangements and matching contributions (sec. 1433) [18]	yba 12/31/98					−45	−166	−171	−175	−180	−186	−191	−196	−1,309
5. Definition of compensation for section 415 purposes (sec. 1434)	yba 12/31/97				−1	−1	−2	−2	−2	−2	−2	−3	−3	−18
D. Miscellaneous Pension Simplification														
1. Plans covering self-employed individuals (sec. 1441)	yba 12/31/96							Negligible Revenue Effect						
2. Elimination of special vesting rule for multiemployer plans (sec. 1442)	yba 12/31/96			[11]	−1	−1	−1	−1	−1	−1	−1	−1	−1	−9
3. Distributions under rural cooperative plans (sec. 1443)	DOE							Negligible Revenue Effect						
4. Treatment of governmental plans under section 415 (sec. 1444)	yba 12/31/94							Negligible Revenue Effect						
5. Uniform retirement age (sec. 1445) [16]	yba 12/31/96			[3]	[3]			Considered in Other Provisions						[3]
6. Contributions on behalf of disabled employees (sec. 1446)	yba 12/31/96							Negligible Revenue Effect						

Provision	Effective											
7. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations (sec. 1447)	tyba 12/31/96	([11])	−1	−1	−1	−2	−2	−2	−2	−2	−2	−15
8. Require section 457 plan assets to be held in trust; transition rule for existing plans (sec. 1448)	DOE	−7	−21	−24	−25	−25	−26	−27	−28	−29	−30	−242
9. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act (sec. 1449)	([19])	−4	−4	−4								−12
10. Multiple salary reduction agreements permitted under section 403(b) (sec. 1450(a))	tyba 12/31/95	Negligible Revenue Effect										
11. Treatment of Indian tribal governments under section 403(b) (sec. 1450(b))	cpb 1/1/95	Negligible Revenue Effect										
12. Application of elective deferral limit to section 403(b) plans (sec. 1450(c))	tyba 12/31/95	Negligible Revenue Effect										
13. Allow waiver of 30-day waiting period for qualified plan distributions (sec. 1451)	pyba 12/31/96	Negligible Revenue Effect										
14. Repeal of combined plan limit (sec. 1452)	lyba 12/31/99				−72	−195	−201	−207	−213	−219	−226	−1,333
15. 3-year waiver of excess distribution tax (sec. 1452)	1/1/97	42	44	47	32							165
16. Increase section 4975 excise tax on prohibited transactions from 5% to 10% (sec. 1453)	ptoa DOE	2	4	4	4	4	4	4	4	4	4	38
17. Treatment of leased employees (sec. 1454)	yba 12/31/96	Negligible Revenue Effect										
18. Uniform penalty provision to apply to certain pension reporting requirements (sec. 1455)	1/1/97	No Revenue Effect										
19. Clarify that SECA does not apply to certain parsonage allowance income (sec. 1456)	ybbo/a 12/31/94	Negligible Revenue Effect										
20. Direct IRS to develop model forms for qualified domestic relations orders ("QDRO") and spousal consent provisions (sec. 1457)	DOE	Negligible Revenue Effect										

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
21. Permit volunteer firefighters to make deferrals under section 457 (limited to $3,000 per year) (sec. 1458)	do/a 1/1/97			−2	−5	−7	−9	−11	−13	−16	−18	−20	−23	−124
22. Alternative nondiscrimination rules for certain plans that provide for early participation (sec. 1459)	1/1/99					−6	−17	−18	−19	−19	−20	−20	−20	−139
23. Clarify definition of plan assets (sec. 1460)	1/1/75	Negligible Revenue Effect												
24. Church pension plan simplification (secs. 1461–1463):														
a. Allow pension plan coverage for self-employed clergy	yba 12/31/96	Negligible Revenue Effect												
b. Allow church pension plans to use the new definition of highly compensated employee in the bill—Treasury safe harbor	yba 12/31/96	Negligible Revenue Effect												
c. Allow payroll deduction of pension contributions for clergy on foreign missions	tyba 12/31/96	Negligible Revenue Effect												
25. Grant IRS the discretion to waive pension liquidity shortfall excise tax (sec. 1464)	[19]			−4	−3	−2	−1	[11]	[11]	[11]	[11]	[11]	[11]	−11
26. Date of adoption of plan amendments (sec. 1465)	DOE	No Revenue Effect												
III. Foreign Simplification Provision														
1. Repeal of excess passive assets provision (section 956A) (sec. 1501)	tyba 12/31/96			−11	−22	−29	−36	−41	−45	−51	−57	−64	−71	−427

IV. Other Provisions

Provision	Effective												
1. Exempt from diesel dyeing requirement any States exempt from Clean Air Act dyeing requirement (sec. 1801)	fcqa DOE		[11]	−1	−1	−1	−1	−1	−1	−1	−1	−1	−6
2. Application of common paymaster rules to certain agency accounts at State universities (sec. 1802) [2]	rpa 12/31/96		[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]
3. Modifications to excise tax on ozone-depleting chemicals:													
a. Exempt imported recycled halons from ozone-depleting chemicals tax (sec. 1803(a))	cia 12/31/96		−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−9
b. Suspend excise tax on ozone depleting chemicals used in metered dose inhalers (sec. 1803(b))	DOE + 7 days		−12	−8	−8	−2							−30
4. Alaska Power Authority (sec. 1804):													
a. Authorize tax-exempt bonds for purchase of Alaska Power Authority	bia DOE		−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−10
b. Proceeds from asset sale; foregone receipts from electricity sale [20]	DOE		76	−7	−7	−7	−7	−7	−7	−7	−7	−7	13
5. Allow for tax-free conversion of common trust funds to mutual funds (sec. 1805)	ta 12/31/95	−4	−9	−8	−8	−8	−8	−8	−9	−9	−9	−9	−89
6. Clarify that State prepaid tuition plans are tax-exempt entities; clarify OID rules (sec. 1806)	tyba 12/31/95	Negligible Revenue Effect											
7. $5,000 nonrefundable adoption credit and employer-provided assistance exclusion ($6,000 special needs); non-special needs sunset after 2001; AGI phaseout beginning at $75,000 (sec. 1807)	tyba 12/31/96		−19	−204	−332	−355	−366	−348	−222	−139	−129	−119	−2,234
8. 6-month delay of electronic funds transfer (sec. 1809)	1/1/97	No Revenue Effect											

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
V. Revenue Offsets														
1. Possessions tax credit: Wage credit companies—6 years of present law followed by 4 years subject to income cap, then repealed; Income companies—2 years of present law followed by 8 years subject to income cap, then repealed; QPSII—repealed later of taxable years beginning after 12/31/95 or earnings after 6/30/96 with estimated payment adjustment; special rules for qualifying asset acquisitions (sec. 1601)	tyba 12/31/95		111	697	586	589	490	507	736	1,105	1,378	1,678	2,686	10,563
2. Repeal 50% interest income exclusion for financial institution loans to ESOPs (sec. 1602) (21)	lma DOE		10	64	105	144	182	220	256	292	327	360	327	2,287
3. Apply look-through rule for purposes of characterizing certain subpart F insurance income as UBTI (sec. 1603)	tyba 12/31/95		1	3	4	4	5	5	5	6	6	7	8	54
4. Corporate accounting—reform of income forecast method (sec. 1604)	ppisa 9/13/95		32	69	29	13	14	16	19	22	28	31	35	308
5. Modify exclusion of damages received on account of personal injury or sickness (sec. 1605)	ara DOE		3	50	55	59	61	64	68	71	74	77	80	662
6. Repeal advance refunds of diesel fuel tax for diesel cars and light trucks (sec. 1606)	vpa DOE		1	15	19	19	19	19	19	19	19	19	19	187
7. Phase out and extend luxury automobile excise tax through 12/31/02 (sec. 1607)	so/a DOE + 7 days		−4	−56	−105	−132	124	183	140	32				182

8. Modify two county tax-exempt bond rule for local furnishers of electricity or gas; prohibit new local furnishers (with current service areas grandfathered) (sec. 1608)	(22)			3	−3	−6	−4	−3	(11)	7	13	15	23
9. Reinstate Airport and Airway Trust Fund excise taxes through 12/31/96, with (1) exemption for fixed-wing emergency medical aircraft, and mining, oil, and gas industry helicopters for flights not using FAA services; (2) clarification of collection point; and (3) clarification of tax treatment of travel on corporate aircraft in affiliated groups (sec. 1609)	tp7data DOE	28	1,528	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	(11)	1,555
10. Modify basis adjustment rules under section 1033 (sec. 1610)	ica DOE		1	5	9	14	20	29	37	46	56	64	281
11. Treatment of certain insurance on retired lives (sec. 1611)	tyba 12/31/95		2	1	−2	5	2	(11)	10	−5	2	−3	12
12. Modified guaranteed contracts (sec. 1612)	tyba 12/31/95		−3	3	2	2	−1	−1	(11)	(11)	(11)	(11)	1
13. Tax-free treatment of contributions in aid of construction for water utilities; change depreciation for water utilities (secs. 1613(a) and 1613(b))	(23)		−21	−9	−3	11	24	35	45	55	64	73	274
14. Permit scholarship funding corporation to convert to taxable corporation (sec. 1614)	1/1/97		3	6	8	10	10	9	7	6	5	4	68
15. Apply math error rules for dependency exemptions and filing status when correct taxpayer identification numbers are not provided (sec. 1615)	rd 30 da DOE		133	272	262	249	242	234	226	217	209	201	2,245
16. Repeal bad debt reserve deduction for thrift institutions, with residential loan test for 1996 and 1997 (sec. 1616)	tyba 12/31/95	47	111	216	280	277	272	260	247	111	36	29	1,886
17. Remove business exclusion for energy subsidies provided by public utilities (sec. 1617)	tyba 12/31/96		63	100	104	107	109	111	113	115	116	117	1,055

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
18. Provide for flow through treatment for Financial Asset Securitization Investment Trusts ("FASITs") (sec. 1621)	9/1/97	....	....	....	92	48	8	−3	−9	−14	−19	−25	−32	47
19. Modify treatment of foreign trusts (secs. 1901–1907)	[24]	....	52	143	171	180	188	197	206	214	223	245	260	2.079
VI. Tax Technical Corrections Provisions														
1. Luxury excise tax, and other technical corrections (secs. 1701–1704) [9]		....	14	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	[11]	13
Subtotal: H.R. 3448		....	**67**	**1,133**	**−316**	**250**	**160**	**−269**	**−190**	**347**	**663**	**1,135**	**2,271**	**5,230**
PART FIVE: REVENUE PROVISIONS OF THE HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996 (H.R. 3103)														
I. Tax-Related Health Provisions														
A. Medical savings accounts limited to employers with 50 or fewer employees and self-employed: (a) maximum contribution limit (65% of deductible single and 75% of deductible family); (b) tax-free build up of earnings; (c) definition of qualified medical expenses; (d) clarification relating to capitalization of policy acquisition costs; (e) delay penalty-free withdrawal to age 65; (f) increase penalty-tax from 10% to 15%; (g) coordination of dual benefits for spouses; (h) estate tax preferences are deleted; (i) maximum deductible—$2,250 single, $4,500 family; and (j) cap on taxpayers utilizing MSAs (sec. 301)	1/1/97	....	....	−118	−249	−264	−285	−303	−320	−338	−356	−373	−391	−2,998

Provision	Effective												
B. Increase the self-employed health insurance deduction (40% in 1997; 45% in 1998 through 2002; 50% in 2003; 60% in 2004; 70% in 2005; and 80% in 2006 and thereafter) (sec. 311)	tyba 12/31/96	....	-64	-238	-340	-377	-410	-445	-537	-824	-1,290	-1,827	-6,351
C. Long-term care provisions: (a) deduction for long-term care premiums; (b) deduction for long-term care expenses; (c) exclude employer contributions for long-term care insurance from gross income; (d) allow long-term care premiums to be deducted subject to the self-employed health care rules; (e) change reserve requirements to one-year preliminary term; and (f) exclude from gross income long-term care benefits received, subject to limitations (secs. 321–327)	tyba 12/31/96 & cia 12/31/97	....	-108	-667	-645	-663	-743	-827	-905	-1,009	-1,103	-1,205	-7,874
D. Tax treatment of accelerated death benefits under life insurance contracts (secs. 331–332)	tyba 12/31/96	....	-10	-107	-166	-214	-265	-316	-376	-446	-527	-599	-3,025
E. Exemption from income tax for State-sponsored organizations providing health coverage for high-risk individuals and for State-created organizations providing worker's compensation reinsurance (secs. 341–342)	tyba 12/31/96 & tyea DOE	....	-1	(11)	4	-2	-2	-2	-2	-2	-2	-2	-11
F. Health insurance organizations eligible for benefits of section 833 (sec. 351)	tyea 12/31/96	....	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-11
G. Penalty-free withdrawal from IRAs for medical expenses which exceed 7.5% of AGI and for insurance for unemployed individuals (for health insurance premiums only) without regard to 7.5% floor (sec. 361) (25)	1/1/97	....	-4	-10	-10	-10	-10	-11	-11	-11	-12	-12	-101

Footnotes at end of Appendix.

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS

Fiscal Years 1995–2006

[Millions of dollars]

Provision	Effective	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1995–2006
H. Include an organ donation card with individual income tax refund payments (sec. 371)	rmo/a 2/1/97	No Revenue Effect												
II. Application and Enforcement of Group Health Plan Requirements														
A. Application and enforcement of group health plan portability, access, and renewability requirements (secs. 401–402)	pyba 6/30/97	No Revenue Effect												
B. Clarification of certain COBRA health care continuation requirements (sec. 421)	1/1/97	No Revenue Effect												
III. Revenue Offsets														
A. Disallow interest deduction for corporate-owned life insurance policy loans (phase out disallowance 100% in 1996, 90% in 1997, and 80% in 1998; cap borrowing at 20,000 lives; cap interest rate with special rules for grandfathered plans; exception for key person policies with 20 lives; limit borrowing in 1996 to policies purchased in 1994 and 1995) (sec. 501)	ipoaa 10/13/95			726	833	1,356	1,707	1,784	1,879	1,919	1,930	1,924	1,921	15,979
B. Expatriation tax provisions (secs. 511–513)	2/6/95		52	97	146	199	254	289	304	319	335	351	368	2,714
C. Eliminate interest allocation exception for certain nonfinancial corporations (sec. 521)	DOE		10	73	107	123	141	163	187	201	215	228	242	1,690
Subtotal: H.R. 3103			**62**	**590**	**−186**	**256**	**550**	**502**	**448**	**269**	**−169**	**−805**	**−1,506**	**12**

PART SIX: REVENUE PROVISIONS OF THE PERSONAL RESPONSIBILITY AND WORK OPPORTUNITY RECONCILIATION ACT OF 1996 (H.R. 3724)													
A. Expand the EIC definition of disqualified income and index threshold (sec. 909)	tyba 12/31/95		196	195	178	169	175	185	180	177	168	160	1,782
B. Modify AGI by disregarding certain losses (sec. 910)	tyba 12/31/95		113	125	133	141	154	166	173	183	193	204	1,586
C. EIC compliance provisions (sec. 451)	tyba 12/31/95		252	261	265	272	276	282	289	295	302	309	2,802
Subtotal: H.R. 3724 ([26])			**505**	**517**	**525**	**545**	**561**	**593**	**621**	**646**	**672**	**699**	**5,884**
PART SEVEN: REVENUE PROVISION OF THE ECONOMIC GROWTH AND REGULATORY PAPERWORK REDUCTION ACT OF 1996 (H.R. 3610)													
1. Tax treatment of special assessments paid to the Savings Association Insurance Fund (sec. 2711)	DOE	No Revenue Effect											
Subtotal: H.R. 3610		**No Revenue Effect**											

Joint Committee on Taxation
NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

ara = amounts received after
asda = annuity starting date after
bia = bonds issued after
cia = chemicals imported after
cpb = contracts purchased before
dda = decendents dying after
DDA = disasters declared after
do/a = deferrals on or after
DOE = date of enactment
fcqa = first calendar quarter after
pyba = plan years beginning after
rd 30 da = returns due 30 days after
rda DOE = returns due after date of enactment
rmoa/a = refunds made on or after
rpa = remuneration paid after
so/a = sales on or after
spa = services performed after
ta = transfers after
tyba = taxable years beginning after
tyea = taxable years ending after

Footnotes at end of Appendix.

ica = involuntary conversions after

ipoaa = interest paid or accrued after
lida = leasehold improvements disposed of after
lma = loans made after
lyba = limitation years beginning after
pa = periods after
ppisa = property placed in service after
ppiso/a/b = property placed in service on, after, or before
ptoa = prohibited transactions occurring after

tp7data DOE = tickets purchased 7 days after date of enactment for travel 7 days after date of enactment
yba = years beginning after
ybbo/a = years beginning before, on, or after
vpa = vehicles purchased after
6 ma DOE = 6 months after date of enactment
90 da DOE = 90 days after date of enactment.

Footnotes for Appendix:

[1] Included in this estimate are decreases in EIC outlays of $18 million for FY 1966, $353 million for FY 1997, $397 million for FY 1998, $426 million for FY 1999, $449 million for FY 2000, $495 million for FY 2001, $529 million for FY 2002, $566 million for FY 2003, $605 million for FY 2004, $647 million for FY 2005, and $689 million for FY 2006.
[2] Estimates provided by the Congressional Budget Office.
[3] Negligible revenue effect.
[4] Loss of less than $1 million.
[5] Loss of less than $5 million.
[6] Gain of less than $1 million.
[7] Gain of less than $5 million.
[8] Gain of less than $10 million.
[9] The technical correction relating to expensing is included in the increase in expensing limitation provision.
[10] Effective as if included in the Omnibus Budget Reconciliation Act of 1993.
[11] Loss of less than $500,000.
[12] The provision applies to remuneration paid after 12/31/94, and also is effective with respect to remuneration paid after 12/31/84, and before 1/1/95, unless the payor treated such remuneration (when paid) as being subject to FICA taxes.
[13] Loss of less than $10 million.
[14] Credit rate at 35% on first $6,000 of income; eligible workers expanded to include enterprise zone/community youth, welfare cash recipients, veteran foodstamp recipients, and 18–24 year olds living in a household receiving food stamps for a period of at least 6 months on the date of hire without pre-certification; 400 hour work requirement; 21 day certification requirement.
[15] Loss of less than $30 million.
[16] Revenue effect after 1/1/99 included in the revenue estimate for the safe harbor provision due to interactions between this provision and Item II. Pension Simplification Provisions, C.4.
[17] Loss of less than $15 million.
[18] This provision considers interaction effects of SIMPLE retirement plan provisions (Items II. Pension Simplification Provisions, C.1, C.2, and D.5).
[19] Effective as if included in the General Agreement on Tariffs and Trade of 1994.
[20] Estimate provided by the Congressional Budget Office. Negative numbers indicate that Federal outlays will increase; positive numbers indicate that Federal outlays will decrease.
[21] The repeal would not apply to loans made pursuant to a binding contract entered into before 6/10/96.
[22] Effective generally date of enactment; placed in service before 1/1/97 for limitation on new local furnishers.
[23] Effective for amounts received after 6/12/96 and property placed in service after 6/12/96 with the exception of certain property subject to a binding contract before 6/10/96.
[24] Various effective dates depending on provisions.

[25] Assumes no other provisions which expand the eligibility of IRAs are enacted.
[26] Individual provisions do not add to totals due to interactions.

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