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[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997

PREPARED BY THE STAFF

OF THE

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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 1997.

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. 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 legislation enacted in 1997 in one publication.

Part One of the pamphlet is an explanation of the provisions of the Airport and Airway Trust Fund Reinstatement Act of 1997 (H.R. 668, P.L. 105–2) relating to the temporary extension (through September 30, 1997) of Airport and Airway Trust Fund excise taxes.[2] Part Two is an explanation of the Taxpayer Relief Act of 1997 (H.R. 2014, P.L. 105–34). Part Three is an explanation of the revenue provisions of the Balanced Budget Act of 1997 (H.R. 2015, P.L. 105–33). Part Four is an explanation of the Taxpayer Browsing Protection Act (H.R. 1226, P.L. 105–35) relating to prohibitions on tax return/tax information browsing. Part Five is an explanation of section 9 of S. 1519 (P.L. 105–130). The Appendix provides estimates of the effects of tax legislation enacted in 1997 on Federal fiscal year receipts for 1997–2007.

The first footnote in each part of the pamphlet gives the legislative history of each of the 1997 Acts.

Further, footnote references are included with respect to related provisions in the Tax Technical Corrections Act of 1997 (Title VI of H.R. 2676 as passed by the House on November 5, 1997). The Tax Technical Corrections Act of 1997 was reported by the House Committee on Ways and Means in H.R. 2645 on October 29, 1997 (H. Rept. 105–356), and was added as an amendment to H.R. 2676. (Titles I–V of H.R. 2676, the Internal Revenue Service Restructuring and Reform Act of 1997, was reported by the House Committee on Ways and Means on October 31, 1997; H. Rept. 105–364, Part I.)

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS–23–97), December 17, 1997.

[2] See also section 1031 of the Taxpayer Relief Act of 1997 (H.R. 2014, P.L. 105–34) in Part Two of this pamphlet for subsequent extension and modifications to the Airport and Airway Trust fund excise taxes.

PART ONE: AIRPORT AND AIRWAY TRUST FUND EXTENSION ACT OF 1997 (H.R. 668)[3]

Prior Law

Tax rates

Excise taxes are imposed on commercial air passenger and freight transportation and on fuels used in general aviation (i.e., transportation on noncommercial aircraft which is not for hire) to fund the Airport and Airway Trust Fund ("Airport Trust Fund"). These taxes generally had expired after December 31, 1996.

The Airport Trust Fund excise taxes which had expired included three taxes on commercial air transportation:

(1) A 10-percent excise tax on domestic air passenger transportation;

(2) A $6 per person international air passenger departure tax; and

(3) A 6.25-percent domestic air freight excise tax.

Noncommercial aviation (e.g., corporate aircraft) was subject to Airport Trust Fund excise taxes on the fuels it used rather than the commercial aviation passenger ticket and freight excise taxes. The Airport Trust Fund rates for these excise taxes were 17.5 cents per gallon for jet fuel and 15 cents per gallon for aviation gasoline.

Collection and deposit of tax

The air passenger ticket and freight excise taxes are collected from passengers and freight shippers by the commercial air carriers. The air carriers then remit the funds to the Treasury Department; however, the air carriers are not required to remit monies immediately. Excise tax returns are filed quarterly (similar to annual income tax returns) with taxes being deposited on a semi-monthly basis (similar to estimated income taxes). For air transportation sold during a semi-monthly period, air carriers may elect to treat the taxes as collected on the last day of the first week of the second following semi-monthly period.[4] Under these "deemed collected" rules, for example, the taxes on air transportation sold between October 1 and October 15, are treated as collected by the air carriers on or before November 7. These amounts generally must be deposited with the Treasury by November 10. Thus, on average, revenues from commercial air passenger transportation generally are not received by the Federal Government until approxi-

[3] P.L. 105–2; February 28, 1997. H.R. 668 was reported by the House Committee on Ways and Means on February 13, 1997 (H. Rept. 105–5). The bill was passed by the House on February 26, 1997, and by the Senate on February 27, 1997. H.R. 668 was signed by the President on February 28, 1997.

See also Part Two for a description of the subsequent 10-year extension and modification of the Airport Trust Fund excise taxes in the Taxpayer Relief Act of 1997 (sec. 1031 of H.R. 2014).

[4] Air carriers generally make this election because it allows them to delay remitting tax beyond the date when remittance otherwise would be required.

mately one month after the air carrier actually sells the transportation.

Like income tax withholding and estimated tax payments, the excise taxes contain payment safe harbors for avoiding underpayment penalties. In general, Treasury Department regulations provide that commercial air carriers are not subject to underpayment penalties if their semi-monthly deposits of passenger ticket and freight waybill taxes for a quarter equal to least the amount of taxes they were required to remit during the second preceding calendar quarter (the "look back" rules). For example, air carriers generally would not be subject to underpayment penalties if their semi-monthly deposits for the fourth quarter (October 1 through December 31) equaled at least the amount they were required to remit during the second quarter (April 1 through June 30) of the same year.

In a general information letter to the Air Transport Association of America, dated August 30, 1996, the Internal Revenue Service advised the air carriers that, notwithstanding that no excise taxes were required to be remitted during a look-back quarter, applicable Treasury Department regulations in 1997 permitted the air carriers to continue to avail themselves of the safe harbor and avoid remitting taxes collected from consumers during September, October, and November of 1996 until the air carriers filed their quarterly excise tax returns for that period on February 28, 1997. (Similarly, the air carriers were expected to retain most taxes collected from consumers during December 1996 until their excise tax returns for the first quarter of 1997 were due on May 31, 1997.)

Trust fund deposits

The Airport Trust Fund received gross receipts attributable to the excise taxes described above. The Code provided that taxes received by the Treasury Department through the end of the period when the taxes were last imposed (i.e., through December 31, 1996 at the time of the legislation) were deposited in the Airport Trust Fund. Thus, under prior law, taxes received after December 31, 1996, were not transferred to the Airport Trust Fund.

Reasons for Change

The Treasury Department credited the Airport Trust Fund with approximately $1.2 billion based on incorrect estimates of excise tax deposits. Subsequently, the Treasury learned that air carriers would not remit taxes attributable to the fourth quarter of 1996 to the Treasury until February 28, 1997. The Treasury Department planned to reverse this error. As a result, the combination of the remaining uncommitted balance in the Airport Trust Fund and General Fund appropriations available to the FAA were believed to be sufficient only to support the FAA's operational expenses through the fiscal year 1997, and to allow new capital commitments (assuming previously anticipated commitment levels) to be made through March 1997. However, because best available estimates of the effect of this error on the FAA budget did not include any estimates of the costs of terminating certain multiple phase contracts, the FAA projected that it would have to stop making new commitments and begin notifying contractors of its intent to

terminate multiple phase contracts on March 1, 1997, or earlier, absent legislative action.

The Congress determined that a short-term extension of the Airport Trust Fund excise taxes was needed in order to fund the FAA budget commitments through the fiscal year ending September 30, 1997, and to give Congress time for review of proposals related to a longer-term extension of the aviation taxes.

Explanation of Provision

Reinstate air transportation excise taxes

The Act reinstated the air transportation excise taxes that expired after December 31, 1996, during the period beginning seven days after the date of enactment and ending after September 30, 1997.

Transfer revenues to the Airport Trust Fund

The Act authorized the Treasury Department to transfer to the Airport Trust Fund receipts attributable to excise taxes described above that were imposed on commercial and general aviation. This permitted transfer of receipts attributable to taxes imposed both during the period August 27, 1996, through December 31, 1996, and during the period beginning seven days after the date of enactment.

Modify Treasury Department excise tax deposit regulations

To prevent a delay in depositing tax similar to that which occurred with respect to the fourth quarter of 1996, the provisions of Treasury Department regulations providing an exception to penalties for underpayment of estimated excise taxes based on a look-back period were made inapplicable when tax was not imposed throughout the look-back period. In such a case, taxpayers could continue to use an alternative safe harbor that provides that no underpayment penalty is imposed as long as the taxpayer has paid at least 95 percent of the current quarter's liability.

Effective Date

The provisions reinstating the commercial air transportation excise taxes were effective for (1) transportation beginning during the period beginning seven days after the date of enactment (March 7, 1997) and ending after September 30, 1997, and (2) amounts paid during such period for transportation occurring after September 30, 1997. Refunds would have been provided for any taxes paid on air passenger and air freight transportation purchased before October 1, 1997, for transportation that occurs at a time when the taxes are not in effect. (This refund provision was rendered moot by provisions of the Taxpayer Relief Act of 1997 (see sec. 1031) that extended the Airport Trust Fund excise taxes, as modified in that Act, for 10 years, through September 30, 2007.)

The provisions reinstating the general aviation gasoline excise tax were effective for gasoline removed during the period beginning seven days after the date of enactment (March 7, 1997) and ending after September 30, 1997. The provision reinstating the general aviation jet fuel excise tax was effective for fuels sold by producers

during the same period. Floor stocks taxes were imposed on these fuels held beyond the removal or producer level on the date which is seven days after the date of enactment (March 7, 1997).

The provisions relating to transfer of receipts to the Airport Trust Fund and the modification of the Treasury Department's excise tax deposit regulations were effective on the date of enactment (February 28, 1997).

Revenue Effect

The provisions are estimated to increase Federal fiscal year budget receipts by $2,730 million in 1997, and to reduce fiscal year budget receipts by $54 million in 1998.

PART TWO: TAXPAYER RELIEF ACT OF 1997 (H.R. 2014)[5]

TITLE I. CHILD TAX CREDIT

A. Child Tax Credit For Children Under Age 17 (sec. 101(a), (b) and (d) of the Act and new sec. 24 of the Code)

Prior Law

In general

Prior law did not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income ("AGI") in arriving at taxable income. The amount of each personal exemption is $2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of $121,200 for single taxpayers, $151,500 for heads of household, and $181,800 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

Reasons for Change

The Congress believed that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases. In part, this is because over the last 50 years the value of the dependent personal exemp-

[5] P.L. 105–34; August 5, 1997. H.R. 2014 was reported by the House Committee on the Budget on June 24, 1997 (H. Rept. 105–148), after the revenue reconciliation provisions were approved by the House Committee on Ways and Means on June 13, 1997. The bill, as amended, was passed by the House on June 26, 1997.

S. 949 was reported by the Senate Committee on Finance on June 20, 1997 (S. Rept. 105–33). The bill was considered by the Senate on June 25–27, 1997, and the provisions of the bill as amended, were incorporated in the Senate-passed version of H.R. 2014 on June 27, 1997. A conference report on H.R. 2014 was filed in the House on July 30, 1997 (H. Rept. 105–220); the House agreed to the conference report on July 31, 1997; and the Senate also agreed to the conference report on July 31, 1997. H.R. 2014 was signed by the President on August 5, 1997.

Two provisions in the conference agreement on H.R. 2014 as passed by the House and the Senate were canceled by the President under the Line Item Veto Act: (1) temporary exceptions under subpart F for certain active financing income; and (2) nonrecognition of gain on the sale of stock in agricultural processors facilities to certain farmer's cooperatives. Modified versions of these two canceled provisions were passed by the House in H.R. 2513, as amended, on November 8, 1997. (See report of the Committee on Ways and Means on H.R. 2513; H. Rept. 105–318, Part I, October 9, 1997. H.R. 2513 was referred to the House Committee on the Budget, and the bill was discharged from the Committee on the Budget on October 22, 1997.)

Further, section 977 of H.R. 2014 (relating to carryback of existing net operating losses of the National Railroad Passenger Corporation (Amtrak)) was contingent on the enactment of Amtrak reform legislation. S. 738 ("Amtrak Reform and Accountability Act of 1997") was reported by the Senate Committee on Commerce, Science, and Transportation on May 14, 1997 (S. Rept. 105–85), and was passed by the Senate, as amended, on November 7, 1997. S. 738 was passed by the House, with amendment, on November 13, 1997, and the Senate agreed to the House amendment on November 13, 1997. S. 738 was signed by the President on December 2, 1997 (P.L. 105–134).

tion has declined in real terms by over one-third. The Congress believed that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values.

Explanation of Provision

In general

Present law provides a $500 ($400 for taxable year 1998) tax credit for each qualifying child under the age of 17. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer.

Phase-out range

For taxpayers with AGI in excess of certain thresholds, the otherwise allowable child credit is phased out. Specifically, the otherwise allowable child credit is reduced by $50 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold ("the modified AGI phase-out"). 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). For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation. The length of the phase-out range is affected by the number of the taxpayer's qualifying children. For example, in 1999, the phase-out range for a single person with one qualifying child will be between $75,000 and $85,000 of modified AGI. The phase-out range for a single person with two qualifying children will be between $75,000 and $95,000 of modified AGI in 1999.

Tax liability limitation; refundable credits

In general, the amount of the child credit, together with the other nonrefundable personal credits, is limited to the excess of the taxpayer's regular tax over the taxpayer's tentative minimum tax (determined without regard to the alternative tax minimum foreign tax credit) (sec. 26(a)).

In the case of an individual with three or more qualifying children, the taxpayer also may be allowed a refundable child credit (sec. 24(d)).[6] The amount of the refundable child credit is the amount that the nonrefundable personal credits would increase if the tax liability limitation of section 26(a) were increased by the excess of the taxpayer's social security taxes over the taxpayer's

[6] The provision is described as set forth in Title VI (sec. 603(a)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

earned income credit (if any).[7] The amount of the refundable child credit is limited to the amount of the child credit allowable under section 24, determined without regard to section 26(a). The social security taxes means the individual's share of FICA taxes and one-half of the SECA tax liability. The amount of the refundable child credit is reduced by the amount of the alternative minimum tax imposed by section 55 that did not result in a reduction of the earned income credit under section 32(h).

The amount of the refundable child credit under section 24(d) will reduce the amount of the nonrefundable child credit (determined without regard to section 26). This will result in the proper calculation of personal credit carryovers.

The following examples illustrate the operation of credit for a taxpayer with three or more qualifying children:

Example 1.—Assume that in 1999, A, an unmarried individual with three qualifying children and an adjusted gross income below $75,000, incurs a regular tax liability in excess of the tentative minimum tax in the amount of $1,000. Assume also that A's employee share of FICA taxes is $3,000. Also assume that A is not entitled to any other credits. A is allowed a $1,000 nonrefundable credit, as limited by section 26(a). A is also allowed a refundable credit of $500 by reason of section 24(d). The amount of this credit is the lesser of (1) $1,500 (the credit that would be allowed under section 24(a) without regard to the tax limitation of section 26) or (2) $500 (the excess of $1,500 (the amount of subpart A credits which would be allowed if A's $3,000 social security taxes were added to the $1,000 section 26(a) limit) over $1,000 (the subpart A credits otherwise allowed)).

Example 2.—Assume the same facts as in example 1, except that A is also allowed a $960 dependent care credit (without regard to section 26). A is allowed $1,000 of nonrefundable credits. A is also allowed a refundable credit of $1,460 by reason of section 24(d). The amount of this credit is the lesser of (1) $1,500 (as in example 1) or (2) $1,460 (the excess of $2,460 (the amount of subpart A credits which would be allowed if A's $3,000 social security taxes were added to the $1,000 section 26(a) limit) over $1,000 (the subpart A credits otherwise allowed)).

Example 3.—Assume the same facts as in example 2, except that A is also allowed a $5,000 adoption credit (without regard to section 26). A is allowed $1,000 of nonrefundable credits. A is also allowed a refundable credit of $1,500. The amount of this credit is the lesser of (1) $1,500 (as in example 2) or (2) $3,000 (the excess of $4,000 (the amount of the subpart A credits which would be allowed if A's $3,000 social security taxes were added to the $1,000 section 26(a) limit) over $1,000 (the subpart A credits otherwise allowed)).

$4,960 of the adoption credit may be carried forward under section 23(c) ($5,000 credit under section 23(a) in excess of $40 (the excess of the $1,000 credit limitation under section 26(a) over the $960 of credits allowed by subpart A other than section 23)). For purposes of computing the credits allowed by subpart A, the $1,500

[7] For this purpose, the earned income credit is determined without regard to the supplemental earned income credit discussed below.

child credit is not taken into account because it is allowed under subpart C.

Supplemental child credit

Part or all of the child credit may be treated as a supplemental child credit under the earned income credit (sec. 32(n)).[8] The amount treated as a supplemental child credit under section 32(n) reduces the amount of the child credit under section 24, but does not change the total amount of child credits allowed and has no effect on determining the amount of any other credit for any taxable year.

The amount of the supplemental child credit is the amount by which the personal credits would be reduced if the section 26(a) tax liability limitation were reduced by an amount equal to the excess of the taxpayer's earned income credit (without regard to the supplemental child credit) over the taxpayer's social security taxes (as defined above). The amount of the supplemental child credit cannot exceed the amount of the nonrefundable child credit under section 24, determined without regard to the tax liability limitation of section 26. The eligibility provisions of section 32 are disregarded in determining the amount of supplemental child credit which is allowed to the taxpayer.

For example, assume an individual with two qualifying children is allowed an earned income credit of $1,300 under section 32(a), has a $500 regular tax liability, no other personal credits, and pays social security taxes of $1,000. Without regard to section 32(n), the individual would be allowed a child credit of $500 under section 24(a), as limited by section 26(a). However, section 32(n) provides that $300 of the child credit will be allowed as supplemental child credit under section 32 rather than as a child credit under section 24. $300 is the amount that the nonrefundable child credit would have been reduced if the section 26(a) limitation had been reduced by the excess of the $1,300 regular earned income credit over the $1,000 social security taxes. Thus, the individual will be allowed a supplemental child credit under section 32(n) of $300 and a child credit under section 24 of $200. This provision will not change the total amount of credits allowed to the taxpayer.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2,710 million in 1998, $18,119 million in 1999, $21,549 million in 2000, $21,401 million in 2001, $21,258 million in 2002, $20,901 million in 2003, $20,430 million in 2004, $19,702 million in 2005, $18,997 million in 2006, and $18,317 million in 2007.

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[8] The provision is described as set forth in Title VI (sec. 603(b)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

B. Expand Definition of High-Risk Individuals with Respect to Tax-Exempt State-Sponsored Organizations Providing Health Coverage (sec. 101(c) of the Act and sec. 501(c)(26) of the Code)

Present and Prior Law

Present and prior law provide 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.[9] 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.

The State or members of the organization are required 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.

Reasons for Change

The Congress believed that including the spouse and certain children of high-risk individuals in the group of individuals to whom such an organization may provide medical care coverage will assist States in providing medical care coverage for uninsured children.

Explanation of Provision

The provision expands the definition of high-risk individuals to include a child of an individual who meets the present-law definition of a high-risk individual, subject to certain requirements. The requirements are: (1) the taxpayer is allowed a deduction for a personal exemption for the child for the taxable year; (2) the child has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins; and (3) the child is a son or daughter of the taxpayer (or a descendant of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer. The definition of high-risk individuals is also expanded to include the spouse of an individual who meets the prior-law definition of a high-risk individual.

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[9] No inference is intended as to the tax treatment of other types of State-sponsored organizations.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998 and by $2 million per year in each of 1999 through 2007.

TITLE II. EDUCATION TAX INCENTIVES

A. Tax Benefits Relating to Education Expenses

1. HOPE tax credit and Lifetime Learning tax credit for higher education tuition expenses (sec. 201 of the Act and new secs. 25A and 6050S of the Code)

Present and Prior Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply, certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the 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. This special rule for employer-provided educational assistance expires with respect to courses beginning after May 31, 2000, and does not apply to graduate-level courses.

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but

not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[10] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools.[11] The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1997, the exclusion is phased out for taxpayers with modified AGI between $50,850 and $65,850 ($76,250 and $106,250 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar lim-

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

[11] The Act amended section 135 to allow taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under that section (as if the proceeds were used to pay qualified higher education expenses) provided that the proceeds from the redemption are contributed to a qualified State tuition program defined under section 529, or to an education IRA defined under section 530, on behalf of the taxpayer, the taxpayer's spouse, or a dependent. Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, includes a technical correction provision that conforms the definition of "eligible educational institution" under section 135 to the broader definition of that term under sections 529 and 530. The result of this technical correction would be that, for purposes of section 135, as under sections 529 and 530, the term "eligible educational institution" would be defined as an institution which is (1) described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) eligible to participate in Department of Education student aid programs.

itation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees (and their spouses and dependents) of certain educational organizations.[12] Section 117(c) specifically provides that the exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

The Act expanded section 108(f) to apply to cancellations of student loans made by an educational organization with its own funds, provided that the cancellation is contingent on the student working for a certain period of time in certain professions for any of a broad class of employers and provided that the student's work satisfies a public service requirement.

Qualified State tuition programs

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain 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

[12] A special rule provides that qualified tuition reductions under section 117(d) may be provided for graduate-level courses in cases of graduate students who are engaged in teaching or research activities for the educational organization (sec. 117(d)(5)).

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). Under the Act, qualified higher education expenses also include certain room and board expenses, provided that the student is enrolled at an eligible educational institution on at least a half-time basis. Section 529 also 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 amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person. Section 529(c)(3)(C) allows tax-free rollovers of credits or account balances in qualified State tuition programs (and redesignations of named beneficiaries) between certain relatives.

Reasons for Change

To assist low- and middle-income families and students in paying for the costs of post-secondary education, the Congress believed that taxpayers should be allowed to claim a credit against Federal income taxes for certain tuition and related expenses incurred when a student attends a college or university (or certain vocational schools).

Explanation of Provisions

HOPE credit

Allowance of credit.—Individual taxpayers are allowed to claim a non-refundable HOPE credit against Federal income taxes up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses.[13] The maximum HOPE credit amount will be indexed for inflation occurring after the year 2000.[14] The qualified

[13] Thus, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the AGI phaseout) for a $1,000 HOPE credit; and if such a student incurs $2,000 of qualified tuition and related expenses, then he or she is eligible for a $1,500 HOPE credit.

[14] The maximum HOPE credit amount will be indexed for inflation occurring after the year 2000, by increasing the cap on qualified tuition and related expenses subject to the 100-percent credit rate and the cap on such tuition and related expenses subject to the 50-percent credit rate, both caps rounded down to the closest multiple of $100. (Some printed versions of the Act

tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.[15]

The HOPE credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). The income phase-out ranges will be indexed for inflation occurring after the year 2000, rounded down to the closest multiple of $1,000. The first taxable year for which the inflation adjustment could be made to increase the income phase-out ranges will be 2002.[16]

The HOPE credit is available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the HOPE credit (rather than repayment of the loan itself).

Dependent students.—A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself is *not* entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

Election of HOPE credit, Lifetime Learning credit, or exclusion from gross income for certain distributions from education IRAs.—For each taxable year, a taxpayer may elect with respect to an eligible student the HOPE credit *or* the "Lifetime Learning" credit (described below), *or* an exclusion from gross income under section 530 for certain distributions from an education IRA (described at A.4, below). Thus, for example, if a parent claims a child as a dependent for a taxable year, then all qualified tuition and related expenses paid by *both* the parent and child are deemed paid by the parent, and the parent may claim the HOPE credit (assuming that the AGI phaseout does not apply) on the parent's return. As an alternative, the parent may elect for that taxable year the Lifetime Learning credit for qualified tuition and related expenses (or an exclusion from gross income for certain distributions from an education IRA) with respect to the dependent child (as described

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incorrectly indicated that the caps would be rounded down to the closest multiple of $1,000.) The first taxable year for which the inflation adjustment could be made to increase the caps on qualified tuition and related expenses will be 2002.

[15] The HOPE credit may not be claimed against a taxpayer's alternative minimum tax (AMT) liability.

[16] If a taxpayer is married (within the meaning of section 7703), the HOPE credit may be available only if the taxpayer and his or her spouse file a joint return for the taxable year.

below).[17] On the other hand, if a child is *not* claimed as a dependent by the parent (or by any other taxpayer) for the taxable year, then the child him- or herself has the option of electing either the HOPE credit, or the Lifetime Learning credit, or the section-530 exclusion for certain distributions from an education IRA for the taxable year.

Qualified tuition and related expenses.—The HOPE credit is available for "qualified tuition and related expenses," meaning tuition and fees required for the enrollment or attendance of an eligible student at an eligible educational institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses are not included. The HOPE credit is not available for expenses incurred to purchase books. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits received by the student during the taxable year. No reduction of qualified tuition and related expenses is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under the provision, a HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.[18]

Eligible students.—An eligible student for purposes of the HOPE credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. (In other words, for at least one academic period which begins during the taxable year, the student must carry at least one-half the normal full-time work load for the course of study the student is pursuing.) To be eligible for the HOPE credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions.—Eligible educational institutions are defined by reference to section 481 of the Higher Edu-

[17] For any taxable year, a taxpayer may claim the HOPE credit for qualified tuition and related expenses paid with respect to one student and also claim the Lifetime Learning credit or the section-530 exclusion with respect to one or more other students. If the HOPE credit is claimed with respect to one student for one or two taxable years, then the Lifetime Learning credit or the section-530 exclusion may be available with respect to that same student for subsequent taxable years.

[18] In addition, the Act amends section 135 to provide that the amount of qualified higher education expenses taken into account for purposes of that section is reduced by the amount of such expenses taken into account in determining the HOPE credit claimed by any taxpayer with respect to the student for the taxable year.

cation Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

Regulations.—The Secretary of the Treasury is granted authority to issue regulations to implement the provision, including regulations providing for a recapture of the HOPE credit where there is a refund of tuition and related expenses with respect to which a credit was claimed in a prior year (sec. 25A(i)). In addition, new Code section 6050S provides that eligible educational institutions which receive payments for qualified tuition and related expenses, and certain other persons who make reimbursements or refunds of qualified tuition and related expenses,[19] are required to furnish information returns to the IRS and students (and individuals claiming the student as a dependent) as prescribed by Treasury Department regulations, in order to assist students, their parents, and the IRS in calculating the amount of the HOPE credit potentially available.

Lifetime Learning credit for qualified tuition and related expenses

Allowance of credit.—The Act provides that individual taxpayers are allowed to claim a nonrefundable "Lifetime Learning" credit against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return will be eligible for the 20-percent Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the 20-percent Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family—that is, the HOPE credit is computed on a per-student basis, while the Lifetime Learning credit is computed on a family-wide basis.

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[19] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, includes a provision that clarifies that, under section 6050S, information returns containing information with respect to qualified tuition and related expenses must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses. Section 6050S will continue to require the filing of information returns by persons engaged in a trade or business if, in the course of such trade or business, the person receives from any individual interest aggregating $600 or more for any calendar year on one or more qualified education loans within the meaning of section 221(e)(1).

The Lifetime Learning credit is phased out ratably over the same phase-out range that applies for purposes of the HOPE credit—i.e., taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). The income phase-out ranges will be indexed for inflation occurring after the year 2000, rounded down to the closest multiple of $1,000. The first taxable year for which the inflation adjustment could be made to increase the income phase-out ranges will be 2002.[20]

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit (rather than repayment of the loan itself).

Dependent students.—As with the HOPE credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student him- or herself is *not* entitled to claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

Election of Lifetime Learning credit, HOPE credit, or exclusion from gross income for certain distributions from education IRAs.—A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit (or claims the section-530 exclusion for distributions from an education IRA) for that same taxable year with respect to *other* students. If, for a taxable year, a taxpayer claims a HOPE credit with respect to a student (or claims an exclusion for certain distributions from an education IRA with respect to a student), then the Lifetime Learning credit will *not* be available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years).

Qualified tuition and related expenses.—The Lifetime Learning credit is available for "qualified tuition and related expenses," meaning tuition and fees required for the enrollment or attendance of the eligible student at an eligible institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses are not included. The Lifetime Learning credit is not available for expenses incurred to purchase books. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.

[20] If a taxpayer is married (within the meaning of section 7703), the Lifetime Learning credit may be available only if the taxpayer and his or her spouse file a joint return for the taxable year.

In contrast to the HOPE credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.[21]

As with the HOPE credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). No reduction of qualified tuition and fees is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under the provision, a Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.[22]

Eligible students.—In addition to allowing a credit for the tuition and related expenses of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the Lifetime Learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student. Undergraduate and graduate students are eligible for the Lifetime Learning credit. Moreover, in contrast to the HOPE credit, the eligibility of a student for the Lifetime Learning credit does *not* depend on whether or not the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions.—Eligible educational institutions are (as with the HOPE credit) defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

Regulations.—As with the HOPE credit, the Secretary of the Treasury is granted authority to issue regulations to implement the provision, including regulations providing for a recapture of the Lifetime Learning credit where there is a refund of tuition and related expenses with respect to which a credit was claimed in a prior year (sec. 25A(i)). In addition, the new Code section 6050S requires information reporting (as prescribed by Treasury Depart-

[21] The HOPE credit is available only with respect to the first two years of a student's undergraduate education.

[22] In addition, the Act amends present-law section 135 to provide that the amount of qualified higher education expenses taken into account for purposes of that section is reduced by the amount of such expenses taken into account in determining the Lifetime Learning credit claimed by any taxpayer with respect to the student for the taxable year.

ment regulations) by eligible educational institutions which receive payments for qualified tuition and related expenses, and certain other persons who make reimbursements or refunds of qualified tuition and related expenses, in order to assist students, their parents, and the IRS in calculating the amount of the Lifetime Learning credit potentially available.[23]

Effective Date

The HOPE credit is available for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date. The Lifetime Learning credit is available for expenses paid after June 30, 1998, for education furnished in academic periods beginning after such date.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $2,083 million in 1998, $6,469 million in 1999, $7,393 million in 2000, $7,907 million in 2001, $7,707 million in 2002, $8,620 million in 2003, $8,754 million in 2004, $8,893 million in 2005, $9,035 million in 2006, and $9,180 million in 2007.

2. Deduction for student loan interest (sec. 202 of the Act and new sec. 221 of the Code)

Present and Prior Law

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction from income.

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

[23] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, includes a provision that clarifies that, under section 6050S, information returns containing information with respect to qualified tuition and related expenses must be filed by a person that is not an eligible educational institution only if such person is engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds (or similar payments) of qualified tuition and related expenses.

Reasons for Change

The Congress understood that many students incur considerable debt in the course of obtaining undergraduate and graduate education. The Congress believed that permitting a deduction for interest on certain student loans will help to ease the financial burden that such obligations represent.

Explanation of Provision

Under the Act, certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Qualified education loans do not include indebtedness owed to persons related (within the meaning of sections 267(b) or 707(b)(1)) to the taxpayer.

Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under section 135, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that are excludable from the employee's gross income under section 127. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

The maximum deduction is phased in over 4 years, with a $1,000 maximum deduction in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001. The maximum deduction amount is not indexed for inflation. In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of $40,000–$55,000 ($60,000–$75,000 for joint returns); such income ranges will be indexed for inflation occurring after the year 2002, rounded down to the closest multiple of $5,000. Thus, the first taxable year for which the inflation adjustment could be made will be 2003. Modified AGI includes

amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions) as well as amounts excludable from gross income under section 137 (qualified adoption expenses)[24], and is calculated after application of section 86 (income inclusion of certain Social Security benefits), section 219 (deductible IRA contributions), and section 469 (limitation on passive activity losses and credits).[25]

No deduction is allowed for any amount for which a deduction is otherwise allowable under chapter 1 of the Code. In addition, no deduction is allowed for any amount that is disallowed as a deduction under section 261. For example, no deduction would be allowed as interest on a qualified education loan for any amount that is disallowed under section 264 (relating to certain amounts paid in connection with insurance contracts).

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

The Congress expressed its expectation that the Secretary of Treasury will issue regulations setting forth reporting procedures that will facilitate the administration of this provision. Specifically, such regulations should require lenders separately to report to borrowers the amount of interest that constitutes deductible student loan interest (i.e., interest on a qualified education loan during the first 60 months in which interest payments are required). In this regard, the regulations should include a method for borrower certification to a lender that the loan proceeds are being used to pay for qualified higher education expenses. The regulations also should provide guidance as to how a lender can fulfill its reporting obligations (both to borrowers and to the IRS) with respect to interest that constitutes deductible student loan interest in the case of a revolving line of credit.[26]

Effective Date

The provision is effective for interest payments due and paid after December 31, 1997, on any qualified education loan. Thus, in the case of already existing qualified education loans, interest payments qualify for the deduction to the extent that the 60-month period has not expired. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated as a qualified education loan) of such loan are treated as a single loan.

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[24] For purposes of section 137, adjusted gross income is determined without regard to the deduction for student loan interest.

[25] For purposes of sections 86, 135, 219, and 469, adjusted gross income is determined without regard to the deduction for student loan interest.

[26] Such guidance could provide, for example, that interest on loans (or other lines of credit) the proceeds of which are used in part to pay qualified higher education expenses and in part to pay other expenses cannot be reported as qualified education loan interest under this provision unless the portion of the loan or line of credit that is attributable to the qualified higher education expenses is separately stated and accounted for. Under such an approach, interest on a revolving line of credit that is used in part to pay qualified higher education expenses and in part to pay other, nonqualifying expenses generally could not be reported as qualified education loan interest. However, if the amount of the line of credit or loan that is attributable to the higher education expenses is identified at the time the loan is made or the account is established, and such amount is separately accounted for such that the applicable 60-month period and other requirements of the provision, including the lender reporting requirements, can be satisfied, then the interest could be reported as qualified education loan interest.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $18 million in 1998, $69 million in 1999, $122 million in 2000, $204 million in 2001, $277 million in 2002, $308 million in 2003, $326 million in 2004, $346 million in 2005, $368 million in 2006, and $391 million in 2007.

3. Penalty-free withdrawals from IRAs for higher education expenses (sec. 203 of the Act and sec. 72(t) of the Code)

Present and Prior Law

Under present and prior law, amounts held in an individual retirement arrangement ("IRA") generally are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Reasons for Change

The Congress believed that it is both appropriate and important to allow individuals to withdraw amounts from their IRAs for purposes of paying higher education expenses without incurring an additional 10-percent early withdrawal tax.

Explanation of Provision

The Act provides that the 10-percent early withdrawal tax does not apply to distributions from IRAs (including new Roth IRAs created by the Act) if the taxpayer uses the amounts to pay qualified higher education expenses (including those related to graduate-level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the taxpayer or the taxpayer's spouse.

The penalty-free withdrawal is available for "qualified higher education expenses," meaning tuition, fees, books, supplies, and equipment required for enrollment or attendance, at an eligible educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). Certain room and board expenses also are qualified higher education expenses, provided that the student is enrolled at an eligible educational institution at least on a half-time basis. Qualified higher education expenses are reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Effective Date

The provision is effective for distributions after December 31, 1997, with respect to expenses paid after such date for education furnished in academic periods beginning after such date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $78 million in 1998, $201 million in 1999, $181 million in 2000, $175 million in 2001, $177 million in 2002, $179 million in 2003, $182 million in 2004, $184 million in 2005, $186 million in 2006, and $189 million in 2007.

4. Tax treatment of qualified State tuition programs and education IRAs; exclusion for certain distributions from education IRAs used to pay qualified higher education expenses (secs. 211 and 213 of the Act and sec. 529 and new sec. 530 of the Code)

Present and Prior Law

Exclusion for interest earned on savings bonds

Section 135 provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[27] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools.[28] The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1997, the exclusion is phased out for taxpayers with modified AGI between $50,850 and $65,850 ($76,250 and $106,250 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified State tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain 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

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

[28] The Act amended section 135 to allow taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under that section (as if the proceeds were used to pay qualified higher education expenses) provided that the proceeds from the redemption are contributed to a qualified State tuition program defined under section 529, or to an education IRA defined under section 530, on behalf of the taxpayer, the taxpayer's spouse, or a dependent. Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, includes a technical correction provision that conforms the definition of "eligible educational institution" under section 135 to the broader definition of that term under sections 529 and 530. The result of this technical correction would be that, for purposes of section 135, as under sections 529 and 530, the term "eligible educational institution" would be defined as an institution which is (1) described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and (2) eligible to participate in Department of Education student aid programs.

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). Under prior law, qualified higher education expenses did not include any room and board expenses. Section 529 also 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 amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[29]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct any investments made on their behalf by the program. The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program) unless the beneficiaries are members of the same family.[30] 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, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

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[29] Specifically, section 529(c)(3)(A) 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.

[30] For this purpose, the term "member of the family" was defined under prior law by reference to section 2032A(e)(2).

Estate and gift tax rules

In general, a taxpayer may exclude $10,000 of gifts made by an individual ($20,000 in the case of a married couple that elects to split their gifts) to any one donee during a calendar year (sec. 2503(b)).[31] This annual exclusion does not apply to gifts of future interests, and thus may not be applicable to contributions made to a State tuition program.

Under prior law, contributions made to a qualified State tuition program were treated as incomplete gifts for Federal gift tax purposes. Thus, any Federal gift tax consequences were determined at the time that a distribution was 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 was treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) were includible in the contributor's estate for Federal estate tax purposes in the event that the contributor died before such amounts were distributed under the program.

Individual retirement arrangements ("IRAs")

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). Contributions may be made to an IRA for a taxable year up to April 15th of the following year. An individual who makes excess contributions to an IRA, i.e., contributions in excess of $2,000, is subject to an excise tax on such excess contributions unless they are distributed from the IRA before the due date for filing the individual's tax return for the year (including extensions). Under prior law, if the individual (or his or her spouse, if married) is an active participant, the $2,000 limit was phased out between $40,000 and $50,000 of adjusted gross income ("AGI") for married couples and between $25,000 and $35,000 of AGI for single individuals.[32]

Prior law permitted individuals to make nondeductible contributions (up to $2,000 per year) to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions.[33] Earnings on such contributions are includible in gross income when withdrawn.

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. Amounts withdrawn from

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[31] The Act provides that, after 1998, the annual gift-tax exclusion of $10,000 in the case of an individual, or $20,000 in the case of a married couple that splits their gifts, will be indexed for inflation.

[32] The Act increases the income phase-out limits for active participants in employer-sponsored retirement plans and modifies the limit for an individual who is not an active participant but whose spouse is. The Act also creates a new nondeductible IRA called a "Roth IRA." If certain conditions are satisfied, distributions from a Roth IRA are not includible in income. (See Title III.A., below.)

[33] Under the Act, nondeductible contributions are permitted to the extent the individual can not or does not make deductible contributions or contributions to a Roth IRA. (See Title III., A, below.)

an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59-½, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year.[34]

Reasons for Change

To encourage families and students to save for future education expenses, the Congress believed that tax-exempt status should be granted to certain education investment accounts (referred to as "education IRAs"[35]) established by taxpayers on behalf of future students. The Congress further believed that modifications should be made to the rules governing qualified State tuition programs, in order to allow greater flexibility in the use of such programs.

Explanation of Provisions

Qualified State tuition programs

The Act makes the following modifications to present-law section 529, which governs the tax treatment of qualified State tuition programs.

Room and board expenses.—The Act expands the definition of "qualified higher education expenses" under section 529(e)(3) to include room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student. In addition to such room and board expenses, "qualified higher education expenses" include (as under prior law) tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution.

Eligible educational institution.—The Act expands the definition of "eligible educational institution" for purposes of section 529 by defining such term by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions

[34] The Act provides an exception from the early withdrawal tax for withdrawals for qualified higher education expenses (see 3., above) and for withdrawals for first-time home purchase (up to $10,000). (See Title III. A., below.)

[35] "Education IRAs"—although they are referred to as "IRAs" and are subject to some of the same rules as individual retirement arrangements—are not, in fact, individual retirement arrangements within the meaning of the Code.

also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Definition of "member of family".—The Act expands the definition of the term "member of the family" for purposes of allowing tax-free transfers or rollovers of credits or account balances in qualified State tuition programs (and redesignations of named beneficiaries), so that the term means persons described in paragraphs (1) through (8) of section 152(a)—e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc.—and any spouse of such persons.[36]

Prohibition against investment direction.—The Act clarifies the prior-law rule contained in section 529(b)(5) that qualified State tuition programs may not allow contributors or designated beneficiaries to direct the investment of contributions to the program (or earnings thereon) by specifically providing that contributors and beneficiaries may not "directly or indirectly" direct the investment of contributions to the program (or earnings thereon).

Interaction with HOPE credit and Lifetime Learning credit.—Under the Act (as under prior law), no amount will be includible in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) will be includible in the gross income of the distributee.[37] However, to the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and fees, the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or Lifetime Learning credit provided for by the Act with respect to such tuition and fees (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).[38]

Education IRAs

In general.—The Act provides tax-exempt status to "education IRAs," meaning certain trusts (or custodial accounts) which are created or organized in the United States exclusively for the purpose

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[36] The Act also provides a special rule that, in the case of any contract issued prior to August 20, 1996 (i.e., the date of enactment of section 529), section 529(c)(3)(C) will be applied without regard to the requirement that a distribution be transferred to a member of the family (or the requirement that a change in beneficiaries may be made only to a member of the family) in order for such distribution or change in beneficiaries to be tax free.

[37] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that, under rules contained in present-law section 72, distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account, and also makes certain conforming changes to section 72. In particular, the Tax Technical Corrections Act of 1997 provides that, under section 72(e)(8)(B), the determination of the ratio that the aggregate amount of contributions to a qualified State tuition program on behalf of a beneficiary bears to the total balance (or value) of the account for the beneficiary is to be made at the time of the distribution or at such other time as the Secretary of the Treasury may prescribe.

[38] In cases where in-kind benefits are provided to a beneficiary under a qualified State tuition program, section 529(c)(3)(B) provides that the provision of such benefits is treated as a distribution to the beneficiary. Thus, to the extent such in-kind benefits, if paid for by the beneficiary, would constitute payment of qualified tuition and fees for purposes of the HOPE credit or Lifetime Learning credit, the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may be able to claim the HOPE credit or Lifetime Learning credit with respect to payments that are deemed to be made by the beneficiary with respect to the in-kind benefit.

of paying the qualified higher education expenses of a named beneficiary.[39] Contributions to education IRAs may be made only in cash.[40] Annual contributions to education IRAs may not exceed $500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the designated beneficiary reaches age 18.[41] Moreover, the Act imposes a penalty excise tax under section 4973 if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program (defined under sec. 529) on behalf of the same beneficiary.

Phase-out of contribution limit.—The $500 annual contribution limit for education IRAs is phased out ratably for contributors with modified AGI between $95,000 and $110,000 ($150,000 and $160,000 for joint returns). Individuals with modified AGI above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any other individual.

Treatment of distributions.—Amounts distributed from education IRAs are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of an eligible student incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year).[42] If a HOPE credit or Lifetime Learning credit is claimed with respect to a student for a taxable year, then a distribution from an education IRA may (at the option of the taxpayer) be made on behalf of that student during that taxable year, but an exclusion is *not* available under the Act for the earnings portion of such distribution.[43]

Distributions from an education IRA generally will be deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which *may* be excludable from gross income under the Act) by applying the ratio

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[39] Education IRAs generally are not subject to Federal income tax, but are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[40] The Act allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under section 135 (as if the proceeds were used to pay qualified higher education expenses) if the proceeds from the redemption are contributed to an education IRA (or qualified State tuition program) on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In such a case, the beneficiary's basis in the bond proceeds contributed on his or her behalf to the education IRA or qualified tuition program will be the contributor's basis in the bonds (i.e., the original purchase price paid by the contributor for such bonds).

[41] An excise tax penalty may be imposed under present-law section 4973 to the extent that excess contributions above the $500 annual limit are made to an education IRA. However, Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that neither the excise tax penalty under section 4973 nor the additional 10-percent tax under section 530(d)(4) (described *infra*) may be imposed in cases where contributions (and any earnings thereon) are distributed from the education IRA before the date that a return is required to be filed (including extensions of time) by the beneficiary for the year in which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

[42] The exclusion will not be a preference item for alternative minimum tax (AMT) purposes.

[43] If a HOPE credit or Lifetime Learning credit was claimed with respect to a student for an earlier taxable year, the exclusion provided for by the Act may be claimed with respect to the same student for a *subsequent* taxable year with respect to a distribution from an education IRA made in that subsequent taxable in order to cover qualified higher education expenses incurred during that year. Conversely, if an exclusion is claimed for a distribution from an education IRA with respect to a particular student, then a HOPE credit or Lifetime Learning credit will be available in a subsequent taxable year with respect to that same student (provided that no exclusion is claimed in such other taxable years for distributions from an education IRA on behalf of that student and provided that the requirements of the HOPE credit or Lifetime Learning credit are satisfied in the subsequent taxable year).

that the aggregate amount of contributions to the account for the beneficiary bears to the total balance of the account.[44] If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the earnings in their entirety will be excludable from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are *less than* the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the qualified higher education expenses will be deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings will be excludable under the Act (i.e., a portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings will be includible in the distributee's gross income.[45]

Distributions from an education IRA that exceed qualified higher education expenses of the designated beneficiary during the year of the distribution are includible in the distributee's gross income. Moreover, an additional 10-percent tax is imposed on any distribution from an education IRA to the extent that the distribution exceeds qualified higher education expenses of the designated beneficiary (unless the distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary).[46]

The Act allows tax-free (and penalty-free) transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as

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[44] Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, clarifies that, under rules contained in present-law section 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account, and also makes certain conforming changes to section 72. In particular, the Tax Technical Corrections Act of 1997 provides that, under section 72(e)(8)(B), the determination of the ratio that the aggregate amount of contributions to an education IRA bears to the account balance is to be made at the time of the distribution or at such other time as the Secretary of the Treasury may prescribe.

[45] For example, if an education IRA has a total balance of $10,000, of which $4,000 represents principal (i.e., contributions) and $6,000 represents earnings, and if a distribution of $2,000 is made from such an account, then $800 of that distribution will be treated as a return of principal (which under no event is includible in the gross income of the distributee) and $1,200 of the distribution will be treated as accumulated earnings. In such a case, if qualified higher education expenses of the beneficiary during the year of the distribution are at least equal to the $2,000 total amount of the distribution (i.e., principal plus earnings), then the entire earnings portion of the distribution will be excludible under new Code section 530, provided that a HOPE credit or Lifetime Learning credit is not claimed for that same taxable year on behalf of the beneficiary. If, however, the qualified higher education expenses of the beneficiary for the taxable year are less than the total amount of the distribution, then only a portion of the earnings will be excludable from gross income under section 530. Thus, in the example discussed above, if the beneficiary incurs only $1,500 of qualified higher education expenses in the year that a $2,000 distribution is made, then only $900 of the earnings will be excludable from gross income under section 530 (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $1,500 of qualified higher education expenses bears to the $2,000 distribution) and the remaining $300 of the earnings portion of the distribution will be includible in the distributee's gross income.

[46] A technical correction is needed to section 530(d)(4) to clarify that the 10-percent additional tax should not be imposed in cases where a distribution (although used to pay for qualified higher education expenses) is includible in gross income because the taxpayer elects the HOPE or Lifetime Learning credit on behalf of the student for the same taxable year.

well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary.[47]

The legislative history to the Act provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the named beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).[48]

Qualified higher education expenses.—The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, the term "qualified higher education expenses include room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, the Act specifically provides that qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. In addition, qualified higher education expenses do not include expenses paid with amounts that are excludible under section 135. No reduction of qualified higher education expenses is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Qualified higher education expenses do not include any education expense for which a deduction is claimed under section 162 or any other section of the Code.

Eligible educational institution.—Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary

[47] For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)—e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc.—and any spouse of such persons.

[48] A technical correction providing that any balance remaining in an education IRA will be deemed distributed within 30 days after the date that the designated beneficiary reaches age 30 is included in Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Estate and gift tax treatment

For Federal estate and gift tax purposes, any contribution to a qualified State tuition program or education IRA will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present-law gift tax exclusion provided by Code section 2503(b) and also are excludable for purposes of the generation-skipping transfer tax (provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift-tax exclusion limit of $10,000, or $20,000 in the case of a married couple).[49] Contributions to a qualified State tuition program or to an education IRA will not, however, be eligible for the educational expense exclusion provided by Code section 2503(e). In no event will a distribution from a qualified State tuition program or education IRA be treated as a taxable gift.

If a contribution in excess of $10,000 ($20,000 in the case of a married couple) is made in one year—which, under the Act, can occur only in the case of a qualified State tuition program and not an education IRA (which cannot receive contributions in excess of $500 per year)—the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made. For example, a $30,000 contribution to a qualified State tuition program could be treated as five annual contributions of $6,000, and the donor could therefore make up to $4,000 in other transfers to the beneficiary each year without payment of gift tax. Under this rule, a donor may contribute up to $50,000 every five years ($100,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made by the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return.

If a donor making an over-$10,000 contribution to a qualified State tuition program dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor's estate. For example, if a donor makes a $40,000 contribution, elects to treat the transfer as being made over a five-year period, and dies the following year, $8,000 would be allocated to the year of contribution, another $8,000 would be allocated to the year of death, and the remaining $24,000 would be includible in the donor's estate.

If a beneficiary's interest in a qualified State tuition program or education IRA is rolled over to another beneficiary, there are no transfer tax consequences if the two beneficiaries are in the same generation. If a beneficiary's interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or uncle to niece), the

[49] The Act provides that, after 1998, the annual gift-tax exclusion of $10,000 in the case of an individual, or $20,000 in the case of a married couple that splits their gifts, will be indexed for inflation.

five-year averaging rule described above may be applied to exempt up to $50,000 of the transfer from gift tax.

For Federal estate tax purposes, the value of any interest in a qualified State tuition program or education IRA will be includible in the estate of the designated beneficiary. Such interests will not be includible in the estate of the contributor.

The Federal estate and gift tax treatment of qualified State tuition programs and education IRAs has no effect on the actual rights and obligations of the parties pursuant to the terms of the contracts under State law.

Effective Date

The modifications to section 529 generally are effective after December 31, 1997. The expansion of the term "qualified higher education expenses" to cover certain room and board expenses is effective as if included in the Small Business Job Protection Act of 1996 (enacted on August 20, 1996). The provisions governing education IRAs apply to taxable years beginning after December 31, 1997. The gift tax provisions are effective for contributions (or transfers) made after August 5, 1997, and the estate tax provisions are effective for decedents dying after June 8, 1997.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $192 million in 1998, $751 million in 1999, $1,030 million in 2000, $1,190 million in 2001, $1,269 million in 2002, $1,605 million in 2003, $1,925 million in 2004, $2,244 million in 2005, $2,569 million in 2006, and $2,910 million in 2007.

B. Other Education-Related Tax Provisions

1. Extension of exclusion for employer-provided educational assistance (sec. 221 of the Act and sec. 127 of the Code)

Present and Prior Law

Under present and prior law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. Under prior law, the exclusion did not apply to graduate level courses beginning after June 30, 1996. Under prior law, the exclusion expired with respect to courses beginning after June 30, 1997.[50] In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

[50] The legislative history reflects congressional intent that the provision expire with respect to courses beginning after May 31, 1997.

Reasons for Change

The Congress believed that the exclusion for employer-provided education assistance has enabled millions of workers to advance their education and improve their job skills without incurring additional taxes and a reduction in take-home pay. In addition, the exclusion lessens the complexity of the tax laws. Without the special exclusion, a worker receiving educational assistance from his or her employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job-related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

Explanation of Provision

The Act extends the exclusion for employer-provided educational assistance for undergraduate education with respect to courses beginning before June 1, 2000. The exclusion does not apply with respect to graduate level courses.

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 $534 million in 1998, $369 million in 1999, and $250 million in 2000.

2. Modification of $150 million limit on qualified 501(c)(3) bonds other than hospital bonds (sec. 222 of the Act and sec. 150 of the Code)

Present and Prior Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

Present and prior law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. Under prior law, the most significant of these restrictions limited the amount of outstanding bonds from which a section 501(c)(3) organization could benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organiza-

tions under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Reasons for Change

The Congress believed a distinguishing feature of American society is the singular degree to which the United States maintains a private, non-profit sector of higher education and other charitable institutions in the public service. The Congress found inappropriate the restrictions of prior law which placed these section 501(c)(3) organizations at a financial disadvantage relative to substantially identical governmental institutions. For example, a public university generally had unlimited access to tax-exempt bond financing, while a private, non-profit university was subject to a $150 million limitation on outstanding bonds.

Explanation of Provision

The Act repeals the $150 million limit for bonds issued after the date of enactment to finance capital expenditures incurred after the date of enactment. Because this provision of the Act applies only to bonds issued with respect to capital expenditures incurred after the date of enactment, the $150 million limit will continue to govern issuance of other non-hospital qualified 501(c)(3) bonds (e.g., refunding bonds with respect to capital expenditures incurred before the date of enactment or new-money bonds for capital expenditures incurred before that date).[51] Thus, the Congress understood that bond issuers will continue to need Treasury Department guidance on the application of this limit in the future, and expects that the Treasury will continue to provide interpretative rules on this limit.

Effective Date

The provision was effective for bonds issued after the date of enactment (August 5, 1997) to finance capital expenditures incurred after such date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $6 million in 1998, $45 million in 1999, $75 million in 2000, $89 million in 2001, $99 million in 2002, $106 million in 2003, $115 million in 2004, $125 million in 2005, $138 million in 2006, and $162 million in 2007.

3. Expansion of arbitrage rebate exception for certain bonds (sec. 223 of the Act and sec. 148 of the Code)

Present and Prior Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities car-

[51] See colloquy between Senators Moynihan and Roth, *Cong. Record,* July 31, 1997, S8466–67, clarifying that bonds to which the $150 million limit does not apply under the Act are not taken into account in applying the $150 million limit to other bonds.

ried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. In the case of bonds the interest on which is excluded from income, generally, all arbitrage profits earned on investments unrelated to the purpose of the borrowing ("nonpurpose investments") when such earnings are permitted must be rebated to the Federal Government.

An exception is provided for bonds issued by governmental units having general taxing powers if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during the calendar year ("the small-issuer exception"). This exception does not apply to private activity bonds.

Reasons for Change

The Congress recognized the need for additional monies to address public school infrastructure needs. It believed that this provision will reduce the compliance costs of issuers of tax-exempt debt issued for public school construction.

Explanation of Provision

The Act provides that up to $5 million dollars of bonds used to finance public school capital expenditures incurred after December 31, 1997, is excluded from application of the present-law $5 million limit. Thus, otherwise qualified issuers will continue to benefit from the small issue exception from arbitrage rebate if they issue no more than $10 million in governmental bonds per calendar year and no more than $5 million of the bonds is used to finance expenditures other than public school capital expenditures.

Effective Date

The provision is effective for bonds issued after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998, $4 million in 1999, $7 million in 2000, $11 million in 2001, $14 million in 2002, $27 million in 2003, $30 million in 2004, $33 million in 2005, $36 million in 2006, and $38 million in 2007.

4. Enhanced deduction for corporate contributions of computer technology and equipment (sec. 224 of the Act and new sec. 170(e)(6) 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.[52] However, in the

[52] 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)

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

Special rules in the Code provide augmented deductions for certain corporate[53] contributions of inventory property for the care of the ill, the needy, or infants[54] (sec. 170(e)(3)), and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences (sec. 170(e)(4)).[55] Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold.[56] However, the augmented deduction cannot exceed twice the basis of the donated property.

Reasons for Change

The Congress believed that providing an incentive for businesses to invest their computer equipment and software for the benefit of primary and secondary school students will help to provide America's schools with the technological resources necessary to prepare both teachers and students for a technologically advanced present and future.

Explanation of Provision

The Act specifically provides that certain contributions of computer and other equipment to eligible donees to be used for the benefit of elementary and secondary school children qualify for an augmented deduction similar to the deduction currently available under Code section 170(e)(3). Under the Act, qualified contributions mean gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to eligible donees to be used within the United States for educational purposes in any of grades K–12.

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and 170(e)). Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10 percent of their taxable income (computed without regard to the contributions) for the taxable year.

[53] S corporations are not eligible donors for purposes of section 170(e)(3) or section 170(e)(4).

[54] Treas. Reg. sec. 1.170A–4(b)(2)(ii)(F) defines an "infant" as a minor child (as determined under the laws of the jurisdiction in which the child resides). Treas. Reg. sec. 1.170A–4(b)(2)(ii)(G) provides that the "care of an infant" means performance of parental functions and provision for the physical, mental, and emotional needs of the infant.

[55] Eligible donees under section 170(e)(3) are public charities (but not governmental units) and private operating foundations. Eligible donees under section 170(e)(4) are limited to post-secondary educational institutions, scientific research organizations, and certain other organizations that support scientific research.

[56] For purposes of section 170(e)(3), however, no deduction is allowed for any portion of gain that would have been recognized as ordinary income (had the property been sold) because of the application of the recapture provisions in sections 617, 1245, 1250, or 1252. No such limitation applies under section 170(e)(4) because qualified contributions for purposes of section 170(e)(4) are limited to nondepreciable inventory property.

Eligible donees are (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on, and (2) Code section 501(c)(3) entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.[57]

The Act generally provides that the donee organizations cannot transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.[58]

The special treatment applies only to donations made by C corporations; as under present law section 170(e)(4), S corporations, personal holding companies, and service organizations are not eligible donors.

Effective Date

The provision is effective for contributions made in taxable years beginning after December 31, 1997, and before January 1, 2001.[59]

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $46 million in 1998, $48 million in 1999, $77 million in 2000, $49 million in 2001, $5 million in 2002, and $1 million in 2003.

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[57] In the case of depreciable trade or business property, the limitation of section 170(e)(3)(C) does not apply for purposes of determining the amount of the deduction under the provision. Thus, a deduction is allowed under the provision for a portion of the gain that would have been recognized as ordinary income (had the property been sold) because of the application of the recapture provisions relating to depreciation, certain mining and exploration expenditures, certain soil and water conservation expenditures, and certain land-clearing expenditures.

[58] In the case of contributions made through private foundations, the Act permits the payment by the ultimate recipient to the private foundation of shipping, transfer, and installation costs.

[59] A technical correction is necessary to provide that the provision is effective for contributions made during a three-year period ending December 31, 2000.

5. Treatment of cancellation of certain student loans (sec. 225 of the Act and sec. 108(f) (of the Code)

Present and Prior Law

In the case of an individual, gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (sec. 108(f)).

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion.

Reasons for Change

The Congress believed that it is appropriate to expand present-law section 108(f), so that certain loan cancellation programs of educational organizations receive Federal income tax treatment comparable to that provided for similar government-sponsored programs. This provision promotes the establishment of programs that encourage students to use their education and training in valuable community service.

Explanation of Provision

The Act expands section 108(f) so that an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans[60] and the student is not employed by the lender organization. As under present law, the section 108(f) exclusion applies only if the forgiveness is contingent on

[60] A technical correction is required to clarify that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance *any* existing student loan (and not just loans made by educational organizations). A provision to this effect is included in Title VI (sec. 604(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, in the case of loans made or refinanced by educational organizations (as well as refinancing loans made by certain tax-exempt organizations), the student's work must fulfill a public service requirement.[61] The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Effective Date

The provision applies to discharges of indebtedness after August 5, 1997, the date of enactment.

Revenue Effect

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts in each of 1998 through 2007.

6. Tax credit for holders of qualified zone academy bonds (sec. 226 of the Act and new sec. 1397E of the Code)

Present and Prior Law

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units, including the financing of public schools (Code sec. 103).

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994 (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). The Code provides special tax incentives for certain business activities conducted in empowerment zones and enterprise communities (secs. 1394, 1396, and 1397A). In addition, the Taxpayer Relief Act of 1997 provides for the designation of 22 additional empowerment zones (secs. 1391(b)(2) and 1391(g)).

Explanation of Provision

Under the provision, certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold "qualified zone academy bonds" are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set by the Treasury Department) multiplied by the face amount of the bond. The credit rate applies to all such bonds

[61] A technical correction is required to clarify that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement. A provision to this effect is included in Title VI (sec. 604(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit is includible in gross income (as if it were an interest payment on the bond). The credit may be claimed against regular income tax and AMT liability.[62]

The Treasury Department will set the credit rate each month at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond issued in a given month also is determined by the Treasury Department so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Such present value will be determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are defined as any bond issued by a State or local government, provided that (1) 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community (including empowerment zones designated or authorized to be designated under the Act), or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

A total of $400 million of "qualified zone academy bonds" may be issued in each of 1998 and 1999. The $800 million aggregate bond cap will be allocated to the States according to their respective populations of individuals below the poverty line. A State may carry over any unused allocation into subsequent years. Each State, in turn, will allocate the credit to qualified zone academies within such State.

Effective Date

The provision is effective for qualified zone academy bonds issued after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1998, $27 million in 1999, $43 million in 2000, and $47 million in each of years 2001 through 2007.

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[62] A technical correction may be necessary to clarify that the credit also may be claimed against estimated tax liability on the credit allowance date.

TITLE III. SAVINGS AND INVESTMENT TAX INCENTIVES

A. Individual Retirement Arrangements (secs. 301–304 of the Act and secs. 72, 219, and 408 of the Code and new sec. 408A of the Code)

Present and Prior Law

Under present and prior law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan. Under present and prior law, in the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

Under present and prior law, if the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. Under prior law, the limit was phased out between $40,000 and $50,000 of AGI for married taxpayers filing joint returns, and between $25,000 and $35,000 of AGI for single taxpayers. Under present and prior law, contributions cannot be made to a deductible IRA after age 70½. Under prior law, an individual could make contributions to a nondeductible IRA to the extent the individual could not (or did not) make contributions to a deductible IRA.

Under present and prior law, amounts held in a deductible or nondeductible IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Under present and prior law, distributions from a deductible or nondeductible IRA are required to begin at age 70½. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse.

Under present and prior law, IRAs generally may not be invested in collectibles. Under prior law, coins were considered collectibles, other than coins issued by a State and certain gold and silver coins issued by the U.S. Mint.

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 was a significant savings incentive. However, this incentive was not available to all taxpayers under prior law. Further, the

prior-law income thresholds for IRA deductions were not indexed for inflation so that fewer Americans will be eligible to make a deductible IRA contribution each year. The Congress believed it was appropriate to encourage individual saving and that deductible IRAs should be available to more individuals.

In addition, the Congress believed that some individuals would be more likely to save if funds set aside in a tax-favored account could be withdrawn without tax after a reasonable holding period for retirement or certain special purposes. Some taxpayers might find such a vehicle more suitable for their savings needs.

The Congress believed that providing an incentive to save for certain special purposes was appropriate. The Congress believed that many Americans may have difficulty saving enough to ensure that they will be able to purchase a home. Home ownership is a fundamental part of the American dream.

The Congress believed that the prior-law rules relating to deductible IRAs penalize American homemakers. The Congress believed that an individual should not be precluded from making a deductible IRA contribution merely because his or her spouse participates in an employer-sponsored retirement plan.

Finally, the Congress believed that IRAs should not be precluded from investing in bullion.

Explanation of Provision

In general

The Act (1) increases the AGI phase-out limits for deductible IRAs, (2) modifies the AGI phase-out limits for an individual who is not an active participant in an employer-sponsored retirement plan but whose spouse is, (3) provides an exception from the early withdrawal tax for withdrawals for first-time home purchase (up to $10,000),[63] and (4) creates a new nondeductible IRA called the Roth IRA. Individuals with AGI below certain levels may make nondeductible contributions of up to $2,000 annually to a Roth IRA. In addition, the $2,000 maximum contribution limit is reduced to the extent an individual makes contributions to any other IRA in the same taxable year. A Roth IRA is an IRA which is designated at the time of establishment as a Roth IRA in the manner prescribed by the Secretary. Qualified distributions from a Roth IRA are not includible in income.

The Act modifies the prior-law rules relating to nondeductible IRAs. Thus, an individual may make nondeductible contributions to an IRA to the extent they cannot or do not make deductible contributions and contributions to a Roth IRA.

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[63] The Act also provides for penalty-free withdrawals from IRAs for education expenses. (See Title II.A.3., above.) The penalty-free withdrawal exceptions for first-time homebuyer and education expenses do not apply to distributions from employer-sponsored retirement plans. A technical correction may be necessary to prevent the avoidance of the early withdrawal tax by participants in employer-sponsored retirement plans who roll over hardship distributions into an IRA and withdraw the funds from the IRA. A technical correction to that effect is included in Title VI (sec. 605) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. The technical correction would provide that hardship distributions cannot be rolled over into an IRA.

Modification to active participant rule and increase income phase-out ranges for deductible IRAs

Under the Act, the maximum deductible IRA contribution for an individual who is not an active participant in an employer-sponsored retirement plan, but whose spouse is, is phased out for taxpayers with AGI between $150,000 and $160,000.

Under the Act, the deductible IRA income phase-out limits are increased as follows:

Joint Returns

Taxable years beginning in:	*Phase-out range*
1998	$50,000—60,000
1999	51,000—61,000
2000	52,000—62,000
2001	53,000—63,000
2002	54,000—64,000
2003	60,000—70,000
2004	65,000—75,000
2005	70,000—80,000
2006	75,000—85,000
2007 and thereafter	80,000—100,000

Single Taxpayers

Taxable years beginning in:	*Phase-out range*
1998	$30,000—40,000
1999	31,000—41,000
2000	32,000—42,000
2001	33,000—43,000
2002	34,000—44,000
2003	40,000—50,000
2004	45,000—55,000
2005 and thereafter	50,000—60,000

The following examples illustrate the income phase-out rules.

Example 1.—W is an active participant in an employer-sponsored retirement plan, and W's husband, H, is not. Further assume that the combined AGI of H and W for the year is $200,000. Neither W nor H is entitled to make deductible contributions to an IRA for the year.

Example 2.—Same as example 1, except that the combined AGI of W and H is $125,000. H can make deductible contributions to an IRA. However, a deductible contribution could not be made for W.

Modifications to early withdrawal tax

The Act provides that the 10-percent early withdrawal tax does not apply to withdrawals from an IRA (including a Roth IRA) for up to $10,000 of first-time homebuyer expenses.[64]

Under the Act, qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the individual's lifetime that are used within 120 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the individual, the individual's spouse, or a child, grandchild, or ancestor of the individual or individual's spouse. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The Act requires that the spouse of the individual also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition is the date the individual enters into a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. Principal residence is defined as under the provisions relating to the rollover of gain on the sale of a principal residence.

Under the Act, any amount withdrawn for the purchase of a principal residence is required to be used within 120 days of the date of withdrawal. The 10-percent additional tax on early withdrawals is imposed with respect to any amount not so used. If the 120-day rule cannot be satisfied due to a delay in the acquisition of the residence, the taxpayer may recontribute all or part of the amount withdrawn to a Roth IRA prior to the end of the 120-day period without adverse tax consequences.

IRA investments in coins and bullion

Under the Act, IRA assets may be invested in certain bullion. The Act applies to any gold, silver, platinum or palladium bullion of a fineness equal to or exceeding the minimum fineness required for metals which may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission. The provision does not apply unless the bullion is in the physical possession of an IRA trustee. The Act also provides that IRA assets may be invested in certain platinum coins issued by the U.S. mint.[65]

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[64] The Act also provides for penalty-free withdrawals from IRAs for education expenses. (See Title II.A.3., above.) The penalty-free withdrawal exceptions for first-time homebuyer and education expenses do not apply to distributions from employer-sponsored retirement plans. A technical correction may be necessary to prevent the avoidance of the early withdrawal tax by participants in employer-sponsored retirement plans who roll over hardship distributions into an IRA and withdraw the funds from the IRA. A technical correction to that effect is included in Title VI (sec. 605) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. The technical correction would provide that hardship distributions cannot be rolled over into an IRA.

[65] The Act does not modify the prior-law rule permitting IRAs to be invested in State coins and certain coins issued by the U.S. Mint.

Roth IRAs

Contributions to Roth IRAs

The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.[66]

Contributions to a Roth IRA may be made even after the individual for whom the account is maintained has attained age 70½.

Taxation of distributions

Qualified distributions from a Roth IRA are not includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to a Roth IRA,[67] and (2) which is (a) made on or after the date on which the individual attains age 59½, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) a qualified special purpose distribution. A qualified special purpose distribution is a distribution that is exempt from the 10-percent early withdrawal tax because it is for first-time homebuyer expenses.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

An ordering rule applies for purposes of determining what portion of a distribution that is not a qualified distribution is includible in income. Under the ordering rule, distributions from a Roth IRA are treated as made from contributions first, and all of an individual's Roth IRAs are treated as a single Roth IRA. Thus, no portion of a distribution from a Roth IRA is treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's Roth IRAs exceeds the amount of contributions.

The pre-death minimum distribution rules that apply to IRAs generally do not apply to Roth IRAs.

Distributions from a Roth IRA may be rolled over tax free to another Roth IRA.

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[66] For this purpose, AGI does not include amounts includible in income as a result of a conversion of an IRA into a Roth IRA. It was intended that the phase-out range for married taxpayers filing separately be $0 to $10,000. A technical correction is necessary so that the statute reflects this intent. See Title VI (sec. 605) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[67] As is the case with IRAs generally, contributions to a Roth IRA may be made for a year by the due date for the individual's tax return for the year (determined without regard to extensions). In the case of a contribution to a Roth IRA made after the end of the taxable year, the 5-year holding period begins with the taxable year to which the contribution relates, rather than the year in which the contribution is actually made.

Conversions of an IRA to a Roth IRA

All or any part of amounts in a present-law deductible or nondeductible IRA may be converted into a Roth IRA. If the conversion is made before January 1, 1999,[68] the amount that would have been includible in gross income if the individual had withdrawn the converted amounts is included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the conversion is made. The early withdrawal tax does not apply to such conversions.[69]

Under the Act, only taxpayers with AGI of $100,000[70] or less are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple. Married taxpayers filing a separate return are not eligible to make a conversion.

A conversion of an IRA into a Roth IRA can be made in a variety of different ways and without taking a withdrawal. For example, an individual may make a conversion simply by notifying the IRA trustee. Or, an individual may make the conversion in connection with a change in IRA trustees through a rollover or a trustee-to-trustee transfer. If a part of an IRA balance is converted into a Roth IRA, the Roth IRA amounts may have to be held separately.[71]

Effective Date

The provisions are effective for taxable years beginning after December 31, 1997.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year receipts by $367 million in 1998, $345 million in 1999, $346 million in 2001, $860 million in 2002, $1,830 million in 2003, $3,292 million in 2004, $3,842 million in 2005, $4,424 million in 2006, and $5004 million in 2007. The provisions are estimated to increase Federal fiscal year receipts by $86 million in 2000.

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[68] If the conversion is made by means of an actual withdrawal followed by a rollover contribution to a Roth IRA, the withdrawal must occur in 1998 for the 4-year income inclusion rule to apply. In such a case, the 4-year income inclusion begins with the year in which the withdrawal was made, even if the rollover to the Roth IRA does not occur until 1999. As is the case with rollovers generally, a rollover to a Roth IRA must be made within 60 days of the withdrawal from the IRA.

[69] In the case of conversions from an IRA to a Roth IRA, the 5-taxable year holding period begins with the taxable year in which the conversion was made.

[70] For this purpose, AGI is determined before any amount includible in income as a result of the conversion.

[71] The rules relating to conversions of IRAs into Roth IRAs were not intended to allow individuals receiving premature distributions from a Roth conversion IRA while retaining the benefits of 4-year income averaging and the nonpayment of the early withdrawal tax. A technical correction may be necessary so that the statute reflects this intent. See Title VI (sec. 605) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. In general, the proposed technical correction would provide that, if converted amounts are withdrawn within the 5-year period beginning with the year of conversion, then amounts withdrawn which were includible in income due to the conversion would be subject to the 10-percent early withdrawal tax and, if the 4-year income inclusion rule applied to the conversion, an additional 10-percent tax. If the 4-year income inclusion rule applied to the conversion, the converted amounts would still be includible in income under such rule, that is, there would be no acceleration of the income inclusion.

B. Capital Gains Provisions

1. Maximum rate of tax on net capital gain of individuals (sec. 311 of the Act and sec. 1(h) of the Code)

Prior Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain was taxed at the same rate as ordinary income, except that individuals were subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Reasons for Change

The Congress believed it is important that tax policy be conducive to economic growth. Economic growth cannot occur without saving, investment, and the willingness of individuals to take risks. The greater the pool of savings, the greater the monies available for business investment. It is through such investment that the United States' economy can increase output and productivity. It is through increases in productivity that workers earn higher real wages. Hence, greater saving is necessary for all Americans to benefit through a higher standard of living.

The Congress believed that, by reducing the effective tax rates on capital gains, American households will respond by increasing saving. The Congress believed it is important to encourage risk taking and believed a reduction in the taxation of capital gains will have that effect. The Congress also believed that a reduction in the taxation of capital gains will improve the efficiency of the capital markets, because the taxation of capital gains upon realization encourages investors who have accrued past gains to keep their monies "locked in" to such investment even when better investment opportunities present themselves. A reduction in the taxation of capital gains should reduce this "lock in" effect.

Explanation of Provision

Under the Act,[72] the maximum rate of tax on the adjusted net capital gain of an individual is reduced from 28 percent to 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at a 15 percent rate is taxed at a 10 percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. As under prior law, the net capital gain is reduced by the amount of gain which the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d). The Act does not change the definitions in section 1222 relating to capital gains and losses, but rather taxes portions of the net capital gain at different tax rates.[73]

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from property held more than one year but not more than 18 months, long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) held more than 18 months ("collectibles gain and loss"),[74] an amount of gain equal to the amount of gain excluded from gross income under section 1202 relating to certain small business stock ("section 1202 gain"),[75] the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from the sale or exchange of property held more than 18 months,[76] reduced by the net loss (if any) attrib-

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[72] The Act is described as it would be modified by the technical corrections set forth in a letter dated September 29, 1997, to Donald Lubick, Acting Assistant Secretary for Tax Policy, from Chairman Archer, Chairman Roth, Congressman Rangel, and Senator Moynihan. These changes are included in Title VI (sec. 605(d)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[73] Gain from the sale of a capital asset held more than one year remains "long-term capital gain" for purposes of the Code. Thus, for example, the deduction for charitable contributions of appreciated property (under sec. 170(e)) is not changed by this provision.

[74] Only gains taken into account in computing gross income, and only losses taken into account in computing taxable income are included in collectibles gains and losses. See section 1222(l)–(4) for a similar rule in defining various categories of capital gain. A look-through rule is provided in the case of the sale of a partnership interest.

[75] For example, assume an individual has $300,000 gain from the sale of qualified stock in a small business corporation and $120,000 of the gain (50 percent of $240,000) is excluded from gross income under section 1202, as limited by section 1202(b). The entire $180,000 of gain included in gross income is included in the computation of net capital gain and $120,000 of that gain will be taken into account in computing 28-percent rate gain. The combination of the 50-percent exclusion and the 28-percent maximum rate will result in a maximum effective regular tax rate of 14 percent on the $240,000 gain from the sale of the small business stock to which the 50-percent section 1202 exclusion applies, and the maximum rate on the remaining $60,000 of gain is 20 percent.

[76] Section 1250 will continue to treat gain attributable to certain depreciation (generally the amount of depreciation in excess of the amount allowable under the straight-line method) as ordinary income. Thus, for example, assume a taxpayer sold a building for $1 million, which originally cost $500,000, and the taxpayer was allowed $400,000 depreciation of which $100,000 is additional depreciation (as defined in section 1250(b)). As under prior law, $100,000 is treated as ordinary income under section 1250, and $800,000 is treated as long-term capital gain (as-

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utable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year. Thus, if a taxpayer sells a building used in a trade or business held more than 18 months for a gain of $20,000 attributable entirely to depreciation adjustments not otherwise recaptured as ordinary income, and sells land used in a trade or business held for more than one year for a loss of $5,000, the net section 1231 gain is $15,000 and $15,000 (rather than $20,000) will be taken into account in computing the unrecaptured section 1250 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. (secs. 1(h)(1) and 55(b)(3)). Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate will continue to be taxed at the 15-percent rate.[77]

The following examples illustrate the application of these rules. (For purposes of the examples, assume the maximum amount of taxable income in the rate schedule applicable to the individual taxed at the 15-percent rate is $40,000 and the maximum amount of taxable income taxed at a rate below 31 percent is $80,000.)

Example 1.—Assume an individual has taxable income of $100,000, with an adjusted net capital gain of $50,000. $50,000 will be taxed at regular tax rates (i.e., $40,000 at 15 percent and $10,000 at 28 percent), and the $50,000 adjusted net capital gain will be taxed at 20 percent.

Example 2.—Assume an individual has taxable income of $100,000 with an adjusted net capital gain of $70,000. $30,000 will be taxed at regular tax rates (i.e., 15 percent), and $10,000 of the adjusted net capital gain will be taxed at 10 percent and the remaining $60,000 of the adjusted net capital gain will be taxed at 20 percent.

Example 3.—Assume an individual has taxable income of $100,000, with a net capital gain of $50,000, and a 28-percent rate gain of $20,000, resulting in an adjusted net capital gain of $30,000. $50,000 will be taxed at the regular tax rates (i.e., $40,000 at 15 percent and $10,000 at 28 percent), the $30,000 of adjusted net capital gain will be taxed at 20 percent, and the remaining $20,000 will be taxed at 28 percent.

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suming that section 1231(a)(2) does not apply). Under the Act, $300,000 will be taken into account in computing unrecaptured section 1250 gain since, if section 1250 had applied to all depreciation (rather than only additional depreciation), $300,000 of the $800,000 long-term capital gain would have been treated as ordinary income, and only $500,000 would have been treated as long-term capital gain.

In the case of a disposition of a partnership interest held more than 18 months, the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation, will be taken into account in computing unrecaptured section 1250 gain.

[77] In order to arrive at this result, section 1(h)(1) provides that the amount taxed at a 25-percent rate is limited to the net capital gain and is further adjusted to take into account amounts otherwise taxed at the 15-percent rate (or not taxed at all by reason of a taxpayer's ordinary loss), and that the amount taxed at a 28-percent rate is the amount of taxable income reduced by the sum of the amounts taxed at the regular section 1 rates and the 10-, 20-, and 25-percent capital gains rates.

Example 4.—Assume an individual has taxable income of $150,000, with a net capital gain of $50,000, and a 28-percent rate gain of $20,000, resulting in an adjusted net capital gain of $30,000. $100,000 will be taxed at regular tax rates (i.e., $40,000 at 15 percent, $40,000 at 28 percent, and $20,000 at 31 percent), the $30,000 of adjusted net capital gain will be taxed at 20 percent, and the remaining $20,000 will be taxed at 28 percent.

Example 5.—Assume an individual has taxable income of $80,000, with a net capital gain of $50,000, and a 28-percent rate gain of $20,000, resulting in an adjusted net capital gain of $30,000. $40,000 will be taxed at the regular tax rates (i.e., 15 percent); the $30,000 adjusted net capital gain will be taxed at 20 percent; and the remaining $10,000 will be taxed at 28 percent.

Example 6.—Assume an individual has taxable income of $60,000, with a net capital gain of $50,000, and a 28-percent gain of $20,000, resulting in an adjusted net capital gain of $30,000. $30,000 will be taxed at the regular tax rates (i.e., 15 percent); $10,000 of the adjusted net capital gain will be taxed at 10 percent; and $20,000 of the adjusted net capital gain will be taxed at 20 percent.

Example 7.—Assume an individual has taxable income of $40,000, with a net capital gain of $50,000, and a 28-percent rate gain of $20,000, resulting in an adjusted net capital gain of $30,000. $10,000 will be taxed at the regular tax rates (i.e., 15 percent); and the $30,000 adjusted net capital gain will be taxed at 10 percent.

Example 8.—Assume an individual has taxable income of $150,000, with a net capital gain of $50,000, an unrecaptured section 1250 gain of $10,000 and a 28-percent rate gain of $10,000, resulting in an adjusted net capital gain of $30,000. $100,000 will be taxed at regular tax rates (i.e., $40,000 at 15 percent, $40,000 at 28 percent, and $20,000 at 31 percent); the unrecaptured section 1250 gain of $10,000 will be taxed at 25 percent; the $30,000 adjusted net capital gain will be taxed at 20 percent; and the remaining gain of $10,000 will be taxed at 28 percent.

Example 9.—Assume an individual has taxable income of $80,000, with a net capital gain of $50,000, an unrecaptured section 1250 gain of $10,000 and a 28-percent rate gain of $10,000, resulting in an adjusted net capital gain of $30,000. $40,000 will be taxed at the regular tax rates (i.e., 15 percent); the $30,000 adjusted net capital gain will be taxed at 20 percent; and the remaining $10,000 will be taxed at 28 percent. No amount will be taxed at 25 percent.[78]

Example 10.—Assume an individual has taxable income of $60,000, with a net capital gain of $50,000, an unrecaptured section 1250 gain of $10,000, and a 28-percent rate gain of $10,000, resulting in an adjusted net capital gain of $30,000. $30,000 will be taxed at the regular tax rates (i.e., 15 percent); $10,000 of the adjusted net capital gain will be taxed at 10 percent; and $20,000 of the adjusted net capital gain will be taxed at 20 percent.

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[78] The amount taxed at 25 percent is determined by starting with the $10,000 unrecaptured section 1250 gain and subtracting $10,000, which is the excess of $90,000 (i.e., the sum of the amount taxed at the regular rates ($40,000) plus the net capital gain ($50,000)) over $80,000 (i.e., the taxable income). This results in no amount taxed at 25 percent.

Example 11.—Assume an individual has taxable income of $40,000, with a net capital gain of $50,000, an unrecaptured section 1250 gain of $10,000, and a 28-percent rate gain of $10,000, resulting in an adjusted net capital gain of $30,000. $10,000 will be taxed at the regular tax rates (i.e., 15 percent) and the $30,000 adjusted net capital gain will be taxed at 10 percent.

Example 12.—Assume an individual has taxable income of $150,000, with an unrecaptured section 1250 gain of $120,000, and a loss of $20,000 from the sale of a capital asset held more than 18 months, resulting in a net capital gain of $100,000 and no adjusted net capital gain. $50,000 will be taxed at the regular tax rates (i.e., $40,000 at 15 percent and $10,000 at 28 percent); and $100,000 will be taxed at 25 percent.

Example 13.—Assume an individual has taxable income of $150,000, with an unrecaptured section 1250 gain of $90,000, a 28-percent rate gain of $30,000, and a loss of $20,000 from the sale of a capital asset held more than 18 months, resulting in a net capital gain of $100,000 and no adjusted net capital gain. $50,000 will be taxed at the regular tax rates (i.e., $40,000 at 15 percent and $10,000 at 28 percent); the $90,000 unrecaptured section 1250 gain will be taxed at 25 percent and the remaining gain of $10,000 will be taxed at 28 percent.

Example 14.—Assume an individual has taxable income of $150,000, with an unrecaptured section 1250 gain of $110,000, a 28-percent rate gain of $10,000, and a loss of $20,000 from the sale of a capital asset held more than 18 months, resulting in a net capital gain of $100,000 and no adjusted net capital gain. $50,000 will be taxed at the regular tax rates (i.e., $40,000 at 15 percent and $10,000 at 28 percent); and $100,000 (the lesser of unrecaptured section 1250 gain or net capital gain) will be taxed at 25 percent.

For taxable years beginning after December 31, 2000, any gain from the sale or exchange of property held more than 5 years which would otherwise be taxed at the 10-percent rate instead will be taxed at an 8-percent rate.

Any gain from the sale or exchange of property held more than 5 years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate will be taxed at an 18-percent rate. For purposes of determining whether the holding period begins after December 31, 2000, the holding period of any property acquired pursuant to the exercise of an option (or other right or obligation) shall include the period such option (or other right or obligation) was held. Thus, the sale or exchange of property acquired after December 31, 2000, pursuant to the exercise of an option acquired before January 1, 2001, will not qualify for the 18-percent rate.[79] In addition, a taxpayer holding a capital asset or property used in the trade or business on January 1, 2001, may elect to treat the asset as having been sold on such date for an amount equal to its fair market value, and having been reacquired for an amount equal to such value. If the election is made,

[79] The option rule applies solely for purposes of determining whether the property meets the requirement that the holding period began on or after January 1, 2001, in order to determine whether the gain qualifies for the 18-percent maximum rate. It does not apply for determining the holding period for any other purpose of the Code, including whether the 5-year holding period is met.

the asset will be eligible for the 18-percent rate if sold after being held for more than 5 years after December 31, 2000. Any gain resulting from the election will be treated as received on the date of the deemed sale. Any loss will not be allowed (and the disallowed loss will not be added to the basis of the asset). A taxpayer may make the election with respect to some assets and not with respect to others.

The Act[80] contains several conforming amendments to coordinate the multiple holding periods with other provisions of the Code. Inherited property (section 1223(11) and (12)) and certain patents (section 1235) will be deemed to have a holding period of more than 18 months, allowing the lower 10- and 20-percent rates to apply. The Act treats the long-term capital gain or loss on a section 1256 contract as attributable to property held more than 18 months. Rules similar to the short sale holding period rules of section 1233(b) and (d) and the holding period rules of section 1092(f) will apply where the applicable property is held more than one year but not more than 18 months. Amounts treated as ordinary income by reason of section 1231(c) will be allocated among categories of net section 1231 gain in accordance with IRS forms or regulations.[81]

The Act allows the Treasury Department to prescribe regulations applying these capital gains rates to pass-through entities, i.e., regulated investment companies, real estate investment trusts, S corporations, partnerships, estates, trusts, common trust funds, foreign investment companies to which section 1247 applies, and qualified electing funds (as defined in section 1295).

The Act also gives the Treasury Department regulatory authority to modify the application of section 904(b)(2) and (3) to the extent necessary to properly reflect capital gain rate differentials and the computation of net capital gain. These regulations may take into account that the net capital gain includes gains and losses in different categories of income under section 904(d).

These maximum capital gain rates also apply for purposes of computing the alternative minimum tax.[82] In addition, the minimum tax preference (under section 57(a)(7)) for the excluded portion of the gain from certain small business stock is reduced to 42 percent, resulting in an inclusion for minimum tax purposes of 71 percent (50 percent under the regular tax plus an additional 21 percent) of the gain from the sale of small business stock. Thus, the maximum rate of tax on this gain under the minimum tax will be 19.88 percent (.71 of 28 percent). For gains which, but for section 1202, would be taxed at an 18-percent rate beginning in 2006, the minimum tax preference will be 28 percent, resulting in a minimum tax rate of 17.92 percent.[83]

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[80] These provisions were not contained in the 1997 Act itself but are contained the Tax Technical Corrections Act of 1997, Title VI of H.R. 2676 as passed by the House on November 5, 1997.

[81] See IRS Notice 97–59 (Oct. 27, 1997) for rules relating to recharacterizing section 1231 gains under section 1231(c).

[82] The amount of net capital gain, adjusted net capital gain, unrecaptured section 1250 gain and 28-percent rate gain will be computed with any adjustments (such as differences in adjusted bases) used in computing alternative minimum taxable income.

[83] See Title VI (sec. 605(d)(3)) of H.R. 2676, the Tax Technical Corrections Act of 1997 as passed by the House on November 5, 1997.

Effective Date

The provision applies to taxable years ending after May 6, 1997.

Long-term capital gains and losses properly taken into account before May 7, 1997, are taken into account in computing 28-percent rate gain for the taxable year. This generally has the effect of applying the lower rates to capital assets sold or exchanged (or installment payments received) on or after May 7, 1997, and subjecting the earlier portion of the capital gain to the prior-law maximum rate of 28 percent. In the case of gain taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

The 18-month holding period is effective for amounts properly taken into account after July 28, 1997. Thus, amounts properly taken into account after May 6, 1997, and before July 29, 1997, with respect to property (other than collectibles) held more than 1 year but not more than 18 months will be eligible for the 10- and 20-percent rates (as well as the 25-percent rate in the case of the disposition of section 1250 property).

Revenue Effect

The revenue effect of this provision is included in item 5, below.

2. Exclusion of gain on sale of principal residence (sec. 312 of the Act and secs. 121 and 1034 of the Code)

Prior Law

Under prior law, no gain was recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence was purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally began two years before and ended two years after the date of sale of the old residence. The basis of the replacement residence was reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

Also, under prior law, in general, an individual, on a one-time basis, could exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) had attained age 55 before the sale, and (2) had owned the property and used it as a principal residence for three or more of the five years preceding the sale (old sec. 121).

Reasons for Change

Calculating capital gain from the sale of a principal residence was among the most complex tasks faced by a typical taxpayer. Many taxpayers buy and sell a number of homes over the course of a lifetime, and are generally not certain of how much housing appreciation they can expect. Thus, even though most homeowners never paid any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the $125,000 one-time exclusion under prior law, detailed records of transactions and expenditures on home improvements had to be kept, in most cases, for many decades. To claim the exclusion, many taxpayers

had to determine the basis of each home they owned, and appropriately adjust the basis of their current home to reflect any untaxed gains from previous housing transactions. This determination could involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this created, taxpayers faced the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not. The failure to account accurately for all improvements could lead to errors in the calculation of capital gains, and hence to an under- or over-payment of the capital gains on principal residences. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers will have to refer to records in determining income tax consequences of transactions related to their house.

To have postponed the entire capital gain from the sale of a principal residence under prior law, the purchase price of a new home must have been greater than the sales price of the old home. This provision of prior law encouraged some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas. This promoted an inefficient use of taxpayer's financial resources.

Prior law also may have discouraged some older taxpayers from selling their homes. Taxpayers who would have realized a capital gain in excess of $125,000 if they sold their home and taxpayers who had already used the exclusion may have chosen to stay in their homes even though the home no longer suited their needs. By raising the $125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly was removed.

While most homeowners do not pay capital gains tax when selling their homes, prior law created certain tax traps for the unwary that resulted in significant capital gains taxes or loss of the benefits of the prior-law exclusion. For example, an individual was not eligible for the one-time capital gains exclusion if the exclusion was previously utilized by the individual's spouse. This restriction had the unintended effect of penalizing individuals who married someone who had already taken the exclusion. Households that moved from a high housing-cost area to a low housing-cost area may have incurred an unexpected capital gains tax liability. Divorcing couples may have incurred substantial capital gains taxes if they did not carefully plan their house ownership and sale decisions.

Explanation of Provision

Under the Act, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The Act provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997.

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two

of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.[84]

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the Act would allow the newly married taxpayer a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude up to $500,000 of gain on their joint return.

Under the Act, the gain from the sale or exchange of the remainder interest in the taxpayer's principal residence may qualify for the otherwise allowable exclusion.

The provision limiting the exclusion to only one sale every two years by the taxpayer does not prevent a husband and wife filing a joint return from each excluding up to $250,000 of gain from the sale or exchange of each spouse's principal residence provided that each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns.

Effective Date

The provision is available for all sales or exchanges of a principal residence occurring after May 6, 1997, and replaces the present-law rollover and one-time exclusion provisions applicable to principal residences.

A taxpayer may elect to apply present law (rather than the new exclusion) to a sale or exchange (1) made on or before the date of enactment of the Act,[85] (2) made after the date of enactment pursuant to a binding contract in effect on such date or (3) where the replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect of the date of enactment) and the rollover provision would apply. If a taxpayer acquired his or her current residence in a rollover transaction, periods of ownership and use of the prior residence would be taken into account in determining ownership and use of the current residence.

Revenue Effect

The revenue effect of this provision is included in item 5, below.

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[84] The partial exclusion is a fraction of the maximum exclusion (i.e., $250,000 or $500,000 if married filing a joint return), not the realized gain on the sale or exchange. A technical correction may be needed so that the statute reflects this intent. See Title IV (sec. 605(e)) of H.R. 2676, The Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[85] A technical correction may be needed so that the statute reflects Congressional intent that the prior-law election be available to sales or exchanges on the date of enactment. See Title VI (sec. 605(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

3. Exception from real estate reporting requirements for certain sales of principal residences (secs. 312(c) and 701 of the Act and secs. 6045 and 1400C(f) of the Code)

Present and Prior Law

Persons who close real estate transactions are required to file information returns with the IRS. These returns, filed on Form 1099S, are required to show the name and address of the seller of the real estate, details with regard to the gross proceeds of the sale, and the portion of any real property tax which is treated as a tax imposed on the purchaser. Code section 6045(e) also provides for reporting where any financing of the seller was federally-subsidized indebtedness, but Treasury regulations do not currently require the reporting of this information.

Reasons for Change

The Congress believed that information returns should not generally be required on sales of personal residences where there is no possibility of the gain being taxable and information regarding the transaction is not otherwise required to be reported.

Explanation of Provision

The Act excludes most sales of personal residences with a gross sales price of $500,000 or less ($250,000 or less in the case of a seller who is not married) from the real estate transaction reporting requirement. The Secretary of the Treasury has the discretion to increase these dollar thresholds if the Secretary determines that such an increase will not materially reduce revenues to the Treasury. In order to be eligible for this exclusion, the person who would otherwise be required to file the information return must obtain written assurances from the seller of the real estate, in a form acceptable to the Secretary of the Treasury, that any gain will be exempt from Federal income tax under section 121(a).

The Secretary of the Treasury is authorized under present and prior law to require information as to whether there is federally subsidized mortgage financing assistance with respect to mortgages on residences. However, the Secretary does not at this time require such information to be provided in connection with the reporting of real estate transactions under section 6045(e). Should the Secretary require such reporting in the future, the exception to the real estate transaction reporting requirement created by this provision will not apply unless the person otherwise required to file the information return also obtains assurances that there is no such assistance with respect to the mortgage on the residence.

The Act separately establishes a credit of $5,000 for first-time home buyers in the District of Columbia. The Congress anticipates that the Secretary of the Treasury will require such information as is necessary to verify eligibility for the D.C. first-time home buyer credit. In order to allow such information to be collected in an efficient manner, the exclusion from the real estate transaction reporting requirement does not apply to sales of homes that are eligible for this credit, if the Secretary requires such information reporting.

Effective Date

The provision was effective with regard to sales or exchanges occurring after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by a negligible amount.

4. Rollover of gain from sale of certain small business stock (sec. 313 of the Act and sec. 1045 of the Code)

Present and Prior Law

The Revenue Reconciliation Act of 1993 provided individuals a 50-percent exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

Reasons for Change

The Congress hoped that by providing deferral of gain recognition for funds reinvested in qualifying small businesses that investors will make more capital available to the new, small businesses that are important to the long term growth of the economy.

Explanation of Provision

The Act allows an individual[86] to roll over gain from the sale or exchange of small business stock held more than six months where the taxpayer uses the proceeds to purchase other qualifying small business stock within 60 days of the sale of the original stock. For purposes of this provision, the replacement stock must meet the active business requirement of section 1202 for the six-month period following the purchase. The holding period of the replacement stock generally will include the holding period of the stock sold, except that the replacement stock itself must be held for more than six months to do another tax-free rollover.

Effective Date

The provision applies to stock sold after August 5, 1997.

Revenue Effect

The revenue effect of this provision is included in item 5, below.

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[86] Title VI (sec. 605(f)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed the House on November 5, 1997, provides that a partnership or S corporation can roll over gain from small business stock held more than six months if (and only if) all the interests in the partnership or S corporation are held by individuals or estates at all times during the taxable year. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

5. Computation of alternative capital gains tax for corporations (sec. 314 of the Act and sec. 1201 of the Code)

Prior Law

Under prior law, the Code provided that if the regular corporate tax rate exceeded 35 percent, the corporate tax could not exceed a tax computed at the regular tax rates on the taxable income reduced by the net capital gain plus a tax of 35 percent of the net capital gain. Because the regular corporate tax rates do not exceed 35 percent, this provision has no effect under the present and prior law rate structure.

Reasons for Change

The Congress wished to provide a more appropriate formula for taxing the net capital gain of a corporation with an ordinary loss, in the event that the alternative corporate capital gain rate becomes effective at some future time.

Explanation of Provision

The Act provides that the amount taxed at the maximum corporate capital gain rate (under section 1201(a)(2)) may not exceed the amount of a corporation's taxable income. Because the section 1201 alternative rate does not apply under the current rate structure, this change will have no effect without further amendment to the Code.

Effective Date

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

Revenue Effect

The capital gains provisions for items 1, 2, 4 and 5, above, are estimated to increase Federal fiscal year budget receipts in 1997 by $1,254 million, in 1998 by $6,371 million, and in 1999 by $171 million and to reduce Federal fiscal year budget receipts in 2000 by $2,954 million, in 2001 by $2,934 million, in 2002 by $1,785 million, in 2003 by $3,742 million, in 2004 by $3,981 million, in 2005 by $4,179 million, in 2006 by $4,424 million, and in 2007 by $4,958 million.

TITLE IV. ALTERNATIVE MINIMUM TAX PROVISIONS

A. Repeal Alternative Minimum Tax for Small Businesses and Modify the Depreciation Adjustment (secs. 401 and 402 of the Act and secs. 55 and 56 of the Code)

Present and Prior Law

In general

Present law imposes a minimum tax on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual minimum tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount; the corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount. Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment.

The most significant alternative minimum tax adjustment of businesses relates to depreciation. Under prior law, in computing AMTI, depreciation on property placed in service after 1986 was computed by using the class lives prescribed by the alternative depreciation system of section 168(g) and either (1) the straight-line method in the case of property subject to the straight-line method under the regular tax or (2) the 150-percent declining balance method in the case of other property. For regular tax purposes, depreciation on tangible personal property generally is computed using shorter recovery periods and more accelerated methods than are allowed for alternative minimum tax purposes.

Reasons for Change

The Congress believed that the alternative minimum tax inhibits capital formation and business enterprise. Therefore, the Act modified the depreciation adjustment of the alternative minimum tax (the most significant business-related adjustment of the alternative minimum tax) with respect to new investments. In addition, the Congress believed that the alternative minimum tax is administratively complex. Therefore, the Act repealed the alternative minimum tax for small corporations.

Explanation of Provision

Repeal of the alternative minimum tax for small corporations

The alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A corporation that had average gross receipts of less than $5 million for the

three-year period beginning after December 31, 1993,[87] is a small corporation for its first taxable year beginning after December 31, 1997. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million. If a corporation no longer qualifies as a small corporation, it will become subject to the corporate alternative minimum tax only with respect to adjustments and preferences relating to investments made, and transactions entered into, in taxable years beginning with the first taxable year the corporation does not so qualify.

In addition, the alternative minimum tax credit allowable to a small corporation is limited to the amount by which the corporation's regular tax liability (reduced by other credits) exceeds 25 percent of the excess (if any) of the corporation's regular tax (reduced by other credits) over $25,000.

Modification to the depreciation adjustment

For property (including pollution control facilities) placed in service after December 31, 1998, the Act conforms the recovery periods (but not the methods) used for purposes of the alternative minimum tax depreciation adjustment to the recovery periods used for purposes of the regular tax under present law.

Effective Date

Except as provided above, the provision is effective for taxable years beginning after December 31, 1997.

Revenue Effect

The provision that exempts small corporations from the alternative minimum tax is estimated to reduce Federal fiscal year budget receipts by $97 million in 1998, $171 million in 1999, $131 million in 2000, $100 million in 2001, $77 million in 2002, $59 million in 2003, $45 million in 2004, $34 million in 2005, $26 million in 2006, and $20 million in 2007. The provision that modifies the depreciation adjustment is estimated to reduce Federal fiscal year budget receipts $580 million in 1999, $1,653 million in 2000, $2,230 million in 2001, $2,358 million in 2002, $2,561 million in 2003, $2,622 million in 2004, $2,350 million in 2005, $2,044 million in 2006, and $1,920 million in 2007.

B. Repeal AMT Installment Method Adjustment for Farmers (sec. 403 of the Act and sec. 56 of the Code)

Present and Prior Law

The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not in-

[87] Legislative history erroneously refers to the three-year period beginning after December 31, 1994.

clude sales of any property used or produced in the trade or business of farming. For alternative minimum tax purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers. No explicit exception is provided for installment sales of farm property under the alternative minimum tax.

Reasons for Change

The Congress understood that the Internal Revenue Service ("IRS") took the position that the installment method may not be used for sales of property produced on a farm for alternative minimum tax purposes. The Congress further understood that the IRS had announced that it generally will not enforce this position for taxable years beginning before January 1, 1997, so long as the farmer changes its method of accounting for installment sales for taxable years beginning after December 31, 1996.[88] The Congress believed that this issue should be clarified in favor of the farmer.

Explanation of Provision

The Act repeals the minimum tax adjustment relating to the installment method of accounting. Thus, sales reported under the installment method for regular tax purposes may be reported under such method for alternative minimum tax purposes as well.

Effective Date

The provision generally is effective for dispositions in taxable years beginning after December 31, 1987.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1997, $157 million in 1998, $158 million in 1999, $167 million in 2000, $164 million in 2001, $157 million in 2002, and $148 million in 2003; and to increase Federal fiscal year budget receipts by $22 million in 2004, $22 million in 2005, $21 million in 2006, and $21 million in 2007.

[88] Notice 97–13, January 28, 1997.

TITLE V. ESTATE, GIFT, AND GENERATION-SKIPPING TAX PROVISIONS

A. Estate and Gift Tax Provisions

1. Increase in estate and gift tax unified credit; indexing of certain other provisions (sec. 501 of the Act and secs. 2010, 2032A, 2503, 2631, and 6601(j) of the Code)

Present and Prior Law

In general

A gift tax is imposed on lifetime transfers by gift and an estate tax is imposed on transfers at death. 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 taxpayer during his or her lifetime and at death.[89] Under prior law, a unified credit of $192,800 was provided against the estate and gift tax, which effectively exempted the first $600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of $600,000, estate and gift tax rates began at 37 percent and reached 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax was imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[90]

Annual exclusion for gifts

A taxpayer could exclude $10,000 of gifts of present interests in property made by an individual ($20,000 per married couple) to each donee during a calendar year (sec. 2503).

Special use valuation

An executor may elect for estate tax purposes to value certain qualified real property used in farming or a closely-held trade or business at its current use value, rather than its "highest and best use" value (sec. 2032A). The maximum reduction in value under such an election was $750,000.

Generation-skipping transfer ("GST") tax

An individual was allowed an exemption from the GST tax of up to $1,000,000 for generation-skipping transfers made during life or at death (sec. 2631).

Installment payment of estate tax

An executor may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period (sec. 6166). The tax on the first $1,000,000 in value of a closely-held business was eligible for a special 4-percent interest rate (sec. 6601(j)).

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[89] Prior to 1977, separate tax rate schedules applied to the gift tax and the estate tax.

[90] Thus, if a taxpayer made cumulative taxable transfers equaling $21,040,000 or more, his or her average transfer tax rate was 55 percent. The phaseout has the effect of creating a 60-percent marginal transfer tax rate on transfers in the phaseout range.

Reasons for Change

The Congress believed that increasing the amount of the estate and gift tax unified credit would encourage saving, promote capital formation and entrepreneurial activity, and help to preserve existing family-owned farms and businesses. The Congress further believed that increasing the unified credit exemption equivalent amount over time, and annually indexing for inflation the annual exclusion for gifts, the ceiling on special use valuation, the generation-skipping transfer tax exemption, and the ceiling on the value of a closely-held business eligible for the special low interest rate, was appropriate to reduce the transfer tax consequences that result from increases in asset value attributable solely to inflation.

Explanation of Provision

The Act increases the present-law unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1,000,000 in 2006. The increase in the effective exemption is phased in according to the following schedule: the effective exemption is $625,000 for decedents dying and gifts made in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1 million in 2006 and thereafter. The effective exemption amount is not indexed for inflation.

The Act also provides that, after 1998, the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption,[91] and the $1,000,000 ceiling on the value of a closely-held business eligible for the special low interest rate (as modified below), are indexed annually for inflation occurring after 1997. Indexing of the annual exclusion is rounded to the next lowest multiple of $1,000 and indexing of the other amounts is rounded to the next lowest multiple of $10,000.

Conforming amendments to reflect the increased unified credit are made (1) to the 5-percent surtax to conform the phase out of the increased unified credit and graduated rates,[92] (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

Effective Date

The increases in the unified credit are effective for decedents dying, and gifts made, after December 31, 1997. Indexing of the annual exclusion for gifts, the ceiling on special use valuation, the generation-skipping transfer tax exemption, and the ceiling on the value of a closely-held business eligible for the special low interest

[91] A technical correction may be necessary to clarify that indexing of the $1,000,000 generation-skipping transfer tax exemption is effective with respect to all generation-skipping transfers (i.e., direct skips, taxable terminations, and taxable distributions) made after 1998. See Title VI (sec. 606(a)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[92] A technical correction may be necessary to properly phase out the benefits of the unified credit and the graduated rates.

rate is effective for decedents dying, and gifts made, after December 31, 1998.

Revenue Effect

This provision, in combination with the provision described in item 2., below, is estimated to reduce Federal fiscal year budget receipts by $843 million in 1999, $1,259 million in 2000, $1,816 million in 2001, $2,013 million in 2002, $2,596 million in 2003, $2,997 million in 2004, $5,656 million in 2005, $7,279 million in 2006, and $8,638 million in 2007.

2. Estate tax exclusion for qualified family-owned businesses (sec. 502 of the Act and new sec. 2033A of the Code)

Present and Prior Law

Under prior law, there were no special estate tax rules for qualified family-owned businesses. All taxpayers were allowed a unified credit in computing the taxpayer's estate and gift tax, which effectively exempted a total of $600,000 in cumulative taxable transfers from the estate and gift tax (sec. 2010). An executor also could elect, under section 2032A, to value certain qualified real property used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value (up to a maximum reduction of $750,000). In addition, an executor may elect to pay the Federal estate tax attributable to a qualified closely-held business in installments over, at most, a 14-year period (sec. 6166). The tax attributable to the first $1,000,000 in value of a closely-held business was eligible for a special 4-percent interest rate (sec. 6601(j)).

Reasons for Change

The Congress believed that a reduction in estate taxes for qualified family-owned businesses would protect and preserve family farms and other family-owned enterprises, and prevent the liquidation of such enterprises in order to pay estate taxes. The Congress further believed that the protection of family enterprises would preserve jobs and strengthen the communities in which such enterprises are located.

Explanation of Provision

The Act allows an executor to elect special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. The exclusion for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the amount effectively exempted by the unified credit, does not exceed $1.3 million.[93]

[93] A technical correction may be necessary to revise the rules correlating the increase in the unified credit with a decrease in the family-owned business exclusion to ensure that there is neither an increase nor a decrease in the total estate tax on estates holding family-owned businesses as increases in the unified credit are phased in. See Title VI (sec. 606(b)(1)) of H.R. 2676,

Continued

This new exclusion for qualified family-owned business interests is provided in addition to the unified credit (which currently effectively exempts $600,000 of taxable transfers from the estate and gift tax, and will be increased to an effective exemption of $1,000,000 of taxable transfers under other provisions of the Act), the special-use provisions of section 2032A (which permit a qualifying farm or other closely-held business in a decedent's estate to be valued at the value in its current use), and the provisions of section 6166 (which provide for the installment payment of estate taxes attributable to closely held businesses).

Qualified family-owned business interests

For purposes of the provision, a qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. Under the provision, members of an individual's family are defined using the same definition as is used for the special-use valuation rules of section 2032A, and thus include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants. For purposes of applying the ownership tests in the case of a corporation, the decedent and members of the decedent's family are required to own the requisite percentage of the total combined voting power of all classes of stock entitled to vote *and* the requisite percentage of the total value of all shares of all classes of stock of the corporation. In the case of a partnership, the decedent and members of the decedent's family are required to own the requisite percentage of the capital interest, and the requisite percentage of the profits interest, in the partnership.

In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. Each trade or business owned (directly or indirectly) by the decedent and members of the decedent's family is separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest. In applying these tests, any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest. The value of any qualified family-owned business interest held by an entity is treated as being proportionately owned by or for the entity's partners, shareholders, or beneficiaries. In the case of a multi-tiered entity, such rules are sequentially applied to look through each separate tier of the entity.

For example, if a holding company owns interests in two other companies, each of the three entities will be separately tested under the qualified family-owned business interest rules. In deter-

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the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. A further modification may be necessary to reflect Congressional intent.

mining whether the holding company is a qualified family-owned business interest, its ownership interest in the other two companies is disregarded. Even if the holding company itself does not qualify as a family-owned business interest, the other two companies still may qualify if the direct and indirect interests held by the decedent and his or her family members satisfy the requisite ownership percentages and other requirements of a qualified family-owned business interest. If either (or both) of the lower-tier entities qualify, the value of the qualified family-owned business interests owned by the holding company are treated as proportionately owned by the holding company's shareholders.

An interest in a trade or business does not qualify if the business's (or a related entity's) stock or securities were publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in section 543). This personal holding company restriction does not apply to banks or domestic building and loan associations.

The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities. Under the provision, the value of qualified family-owned business interests does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. For this purpose, it is intended that day-to-day working capital needs be determined based on a historical average of the business's working capital needs in the past, using an analysis similar to that set forth in *Bardahl Mfg. Corp.,* 24 T.C.M. 1030 (1965). It is further intended that accumulations for capital acquisitions not be considered "working capital" for this purpose. The value of the qualified family-owned business interests also does not include certain other passive assets. For this purpose, passive assets include any assets that: (1) produce dividends, interest, rents, royalties, annuities and certain other types of passive income (as described in sec. 543(a)); (2) are an interest in a trust, partnership or REMIC (as described in sec. 954(c)(1)(B)(ii)); (3) produce no income (as described in sec. 954(c)(1)(B)(iii)); (4) give rise to income from commodities transactions or foreign currency gains (as described in sec. 954(c)(1)(C) and (D)); (5) produce income equivalent to interest (as described in sec. 954(c)(1)(E)); or (6) produce income from notional principal contracts or payments in lieu of dividends (as described in new secs. 954(c)(1)(F) and (G), added elsewhere in the Act). In the case of a regular dealer in property, such property is not considered to produce passive income under these rules, and thus, is not considered to be a passive asset.

Qualifying estates

A decedent's estate qualifies for the special treatment only if the decedent was a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate (the "50-percent liquidity

test"). For this purpose, qualified heirs include any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family. If a qualified heir is not a citizen of the United States, any qualified family-owned business interest acquired by that heir must be held in a trust meeting requirements similar to those imposed on qualified domestic trusts (under present-law sec. 2056A(a)), or through certain other security arrangements that meet the satisfaction of the Treasury Secretary. The 50-percent liquidity test generally is applied by adding all transfers of qualified family-owned business interests made by the decedent to qualified heirs at the time of the decedent's death, plus certain lifetime gifts of qualified family-owned business interests made to members of the decedent's family,[94] and comparing this total to the decedent's adjusted gross estate. To the extent that a decedent held qualified family-owned business interests in more than one trade or business, all such interests are aggregated for purposes of applying the 50-percent liquidity test.

The 50-percent liquidity test is calculated using a ratio, the numerator and denominator of which are described below.

The numerator is determined by aggregating the value of all qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of qualified business interests that are made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family and were not otherwise includible in the decedent's gross estate. For this purpose, qualified business interests transferred to members of the decedent's family during the decedent's lifetime are valued as of the date of such transfer. This amount then is reduced by all indebtedness of the estate, except for the following: (1) indebtedness on a qualified residence of the decedent (determined in accordance with the requirements for deductibility of mortgage interest set forth in section 163(h)(3)); (2) indebtedness incurred to pay the educational or medical expenses of the decedent, the decedent's spouse or the decedent's dependents; and (3) other indebtedness of up to $10,000.

The denominator is equal to the decedent's gross estate, reduced by any indebtedness of the estate, and increased by the amount of the following transfers, to the extent not already included in the decedent's gross estate: (1) any lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family, plus (2) any transfers of assets other than qualified family-owned business interests from the decedent to the decedent's spouse that were made within 10 years of the date of the decedent's death, plus (3) any other transfers made by the decedent within three years of the decedent's death, except non-taxable

[94] A technical correction may be necessary to clarify the formula for determining the amount of gifts of family-owned business interests made to members of the decedent's family that are not otherwise includible in the decedent's gross estate. See Title VI (sec. 606(b)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

transfers made to members of the decedent's family. The Secretary of the Treasury is granted authority to disregard de minimis gifts. In determining the amount of gifts made by the decedent, any gift that the donor and the donor's spouse elected to have treated as a split gift (pursuant to sec. 2513) is treated as made one-half by each spouse for purposes of this provision.

Participation requirements

To qualify for the beneficial treatment provided under the Act, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) is required to materially participate in the trade or business for at least five years of any eight-year period within 10 years following the decedent's death. For this purpose, "material participation" is defined as under present-law section 2032A (special use valuation) and the regulations promulgated thereunder. See, e.g., Treas. Reg. sec. 20.2032A–3. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) must be considered. Physical work and participation in management decisions are the principal factors to be considered. For example, an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision. For example, if the qualified heir rents his property to his sister on a net cash basis, and his sister materially participates in the business, his sister's participation is sufficient to satisfy the requirement that the qualified heir or a member of his family materially participates in the business.

Recapture provisions

The benefit of the exclusions for qualified family-owned business interests are subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements (i.e., if neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least five years of any eight-year period); (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution under section 170(h); (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. A qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a

trust meeting requirements similar to a qualified domestic trust (as described in present law sec. 2056A(a)), or through certain other security arrangements. For this purpose, a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) does not constitute a disposition of "a portion of a family-owned business interest" that would result in recapture of the benefits of the qualified family-owned business exclusion.

If one of the above recapture events occurs, an additional tax is imposed on the date of such event. As under section 2032A, each qualified heir is personally liable for the portion of the recapture tax that is imposed with respect to his or her interest in the qualified family-owned business. Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test. If she ceases to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the recapture tax; that is, each would be liable for the recapture tax attributable to his or her interest.

The portion of the reduction in estate taxes that is recaptured would be dependent upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than 10 years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis. For example, if the decedent's estate included $2 million in qualified family-owned business interests and $1 million of such interests received beneficial treatment under this proposal, one-half of the value of the interest disposed of is deemed to have received the benefits provided under this proposal.

Effective Date

The provision is effective with respect to the estates of decedents dying after December 31, 1997.

Revenue Effect

This provision, in combination with the provision described in item 1., above, is estimated to reduce Federal fiscal year budget receipts by $843 million in 1999, $1,259 million in 2000, $1,816 million in 2001, $2,013 million in 2002, $2,596 million in 2003, $2,997 million in 2004, $5,656 million in 2005, $7,279 million in 2006, and $8,638 million in 2007.

3. Installment payments of estate tax attributable to closely held businesses (secs. 503 of the Act and secs. 6601(j) and 6166 of the Code)

Present and Prior Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest generally is imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under prior law, a special 4-percent interest rate was applied to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. Interests in holding companies and non-readily-tradable business interests were not eligible for the reduced interest rate under prior or present law.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate.

Reasons for Change

The Congress believed that the provision, by eliminating the deductibility of interest paid on estate taxes deferred under section 6166 (and reducing the interest rate accordingly), would eliminate the need to file annual supplemental estate tax returns and make complex iterative computations to claim an estate tax deduction for interest paid.

Explanation of Provision

The Act reduces the 4-percent interest rate to 2 percent, and makes the interest paid on estate taxes deferred under section 6166 non-deductible for estate or income tax purposes. The 2-percent interest rate is imposed on the amount of deferred estate tax attributable to the first $1,000,000 in *taxable* value of the closely held business (i.e., the first $1,000,000 in value in excess of the effective exemption provided by the unified credit and any other exclusions).[95] The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 is reduced to an amount equal to 45 percent of the rate applicable to underpayments of tax.[96]

Effective Date

The provision is effective for decedents dying after December 31, 1997. Estates deferring estate tax under current law may make a one-time election to use the lower interest rates and forego the interest deduction for installments due after the date of the election (but such estates do not receive the benefit of the increase in the amount eligible for the 6601(j) interest rate—i.e., only the amount that was previously eligible for the 4-percent rate would be eligible for the 2-percent rate).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $9 million in 1999, $17 million in 2000, $25 million in 2001, $33 million in 2002, $41 million in 2003, $47 million in 2004, $53 million in 2005, $58 million in 2006, and $65 million in 2007.

4. Estate tax recapture from cash leases of specially-valued property (sec. 504 of the Act and sec. 2032A of the Code)

Present and Prior Law

A Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under section 2032A, the executor may elect to value certain "qualified real property" used in farming or other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special-use valuation (sec. 2032A(c)).

Under prior law, some courts had held that cash rental of specially-valued property after the death of the decedent was not a qualified use under section 2032A because the heirs no longer bear

[95] The $1,000,000 threshold is indexed under other provisions of the Act.

[96] A technical correction may be necessary to clarify that deferred payments of estate tax on holding companies and non-readily tradable business interests do not qualify for the 2-percent interest rate, but instead are subject to a non-deductible interest rate of 45 percent of the regular deficiency rate. See Title VI (sec. 606(c)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

the financial risk of working the property and, therefore, resulted in the imposition of the additional estate tax under section 2032A(c). See *Martin* v. *Commissioner,* 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); *Williamson* v. *Commissioner,* 93 T.C. 242 (1989), *aff'd,* 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); *Fisher* v. *Commissioner,* 65 T.C.M. 2284 (1993) (cash lease to family member not a qualified use); cf. *Minter* v. *U.S.,* 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); *Estate of Gavin* v. *U.S.,* 1997 U.S. App. Lexis 10383 (8th Cir. 1997) (heir's option to pay cash rent or 50 percent crop share is qualified use).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. (Sec. 2032A(b)(5)). Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Reasons for Change

The Congress believed that cash leasing of farmland among family members was consistent with the purposes of the special-use valuation rules, which are intended to prevent family farms (and other qualifying businesses) from being liquidated to pay estate taxes in cases where members of the decedent's family continue to participate in the business.

Explanation of Provision

The Act provides that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Effective Date

The provision is effective for cash rentals occurring after December 31, 1976.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $25 million in 1998, and $2 million per year thereafter.

5. Clarify eligibility for extension of time for payment of estate tax (sec. 505 of the Act and new sec. 7479 of the Code)

Present and Prior Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally

may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. To qualify for the installment payment election, the business must meet certain requirements. If certain events occur during the repayment period (e.g., the closely held business is sold), full payment of all deferred estate taxes is required at that time.

Under prior law, there was limited access to judicial review of disputes regarding initial or continuing eligibility for the deferral and installment election under section 6166. If the Commissioner determined that an estate was not initially eligible for deferral under section 6166, or had lost its eligibility for such deferral, the estate was required to pay the full amount of estate taxes asserted by the Commissioner as being owed in order to obtain judicial review of the Commissioner's determination.

Reasons for Change

The Congress believed that taxpayers should have access to the courts to resolve disputes over an estate's eligibility for the section 6166 election, without requiring potential liquidation of the assets that the installment provisions of section 6166 are designed to protect.

Explanation of Provision

The Act authorizes the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.[97]

Effective Date

The provision applies to decedents dying after date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $15 million in each of fiscal years 1999-2004, $14 million in 2005, $12 million in 2006, and $11 million in 2007.

6. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations (sec. 506 of the Act and secs. 2001, 6501(c)(9) and 7477 of the Code)

Present and Prior Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made that year and all prior years and then subtracting the tax on the

[97] A technical correction may be necessary to clarify that the jurisdiction of the U.S. Tax Court to determine whether an estate qualifies for installment payment of estate tax on closely-held businesses extends to determining which businesses in an estate are eligible for the deferral. See Title VI (sec. 606(d)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts and the unified credit. Under a special rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is the value that was used to determine the prior year's gift tax. There is no comparable rule in the case of the computation of the estate tax.

Generally, any estate or gift tax must be assessed within three years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the three-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within six years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Under prior law, most courts had permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. See, e.g., *Evanson* v. *United States,* 30 F.3d 960 (9th Cir. 1994); *Stalcup* v. *United States,* 946 F. 2d 1125 (5th Cir. 1991); *Estate of Levin,* 1991 T.C. Memo 1991–208, aff'd 986 F. 2d 91 (4th Cir. 1993); *Estate of Smith* v. *Commissioner,* 94 T.C. 872 (1990). But see *Boatman's First National Bank* v. *United States,* 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

Reasons for Change

Revaluation of lifetime gifts at the time of death requires the taxpayer to retain records for a potentially lengthy period. Rules that encourage a determination within the gift tax statute of limitations ease transfer tax administration by eliminating reliance on stale evidence and reducing the period for which retention of records is required.

Explanation of Provision

The Act provides that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made in calendar years ending after the date of enactment, the Act also extends the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations will not run on an inadequately disclosed transfer in calendar years ending after the date

of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

It is intended that, in order to revalue a gift that has been adequately disclosed on a gift tax return, the IRS must issue a final notice of redetermination of value (a "final notice") within the statute of limitations applicable to the gift for gift tax purposes (generally, three years). This rule is applicable even where the value of the gift as shown on the return does not result in any gift tax being owed (e.g., through use of the unified credit or the annual exclusion). It also is anticipated that the IRS will develop an administrative appeals process whereby a taxpayer can challenge a redetermination of value by the IRS prior to issuance of a final notice.[98]

A taxpayer who is mailed a final notice may challenge the redetermined value of the gift (as contained in the final notice) by filing a motion for a declaratory judgment with the Tax Court. The motion must be filed on or before 90 days from the date that the final notice was mailed. The statute of limitations is tolled during the pendency of the Tax Court proceeding.

Effective Date

The provision generally applies to gifts made after the date of enactment (August 5, 1997). The extension of the special rule under chapter 14 to all gifts applies to gifts made in calendar years ending after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $16 million in 1999, $18 million in 2000, $21 million in 2001, $26 million in 2002, $32 million in 2003, $38 million in 2004, $45 million in 2005, $53 million in 2006, and $61 million in 2007.

7. Repeal of throwback rules applicable to domestic trusts (sec. 507 of the Act and secs. 644(e) and 665 of the Code)

Present and Prior Law

A nongrantor trust is treated as a separate taxpayer for Federal income tax purposes. Such a trust generally is treated as a conduit with respect to amounts distributed currently[99] and taxed with respect to any income which is accumulated in the trust rather than distributed. A separate graduated tax rate structure applies to trusts which historically has permitted accumulated trust income to be taxed at lower rates than the rates applicable to trust bene-

[98] A technical correction to this provision may be necessary. See Title VI (sec. 606(e)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. The technical correction would clarify that in determining the amount of taxable gifts made in preceding calendar periods, the value of prior gifts is the value of such gifts as finally determined, even if no gift tax was assessed or paid on that gift. For this purpose, final determinations would include, e.g., the value reported on the gift tax return (if not challenged by the IRS prior to the expiration of the statute of limitations), the value determined by the IRS (if not challenged through the declaratory judgment procedure by the taxpayer), the value determined by the courts, or the value agreed to by the IRS and the taxpayer in a settlement agreement.

[99] The conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including such distributions in the beneficiaries' income.

ficiaries. This benefit often was compounded through the creation of multiple trusts.

The Internal Revenue Code has several rules intended to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called "throwback" rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous five years is higher than those of the trust.

Under section 643(f), two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is to avoid Federal income tax. For trusts that were irrevocable as of March 1, 1984, section 643(f) applies only to contributions to corpus after that date.

Under prior law, section 644 provided that if property was sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property would be taxed at the contributor's marginal tax rates. In effect, section 644 treated such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

Sections 665 through 668 apply different rules to distributions of previously accumulated trust income from a foreign trust than to distributions of such income from domestic trusts. If a foreign trust accumulates income, changes its situs so as to become a domestic trust, and then makes a distribution that is deemed to have been made in a year in which the trust was a foreign trust, the distribution is treated as a distribution from a foreign trust for purposes of the accumulation distribution rules. Rev. Rul. 91–6, 1991–1 C.B. 89.

Reasons for Change

The throwback rules and section 644 were intended to eliminate the potential tax reduction arising from taxation at the trust level, rather than the beneficiary or contributor level. When those provisions were enacted, a taxpayer could reduce his or her overall tax liability substantially by transferring property to one or more trusts, so that any income from the property would be taxed at lower income tax rates. In the Tax Reform Act of 1984, Congress curtailed the tax avoidance use of multiple trusts. Moreover, in the Tax Reform Act of 1986, Congress provided a new rate schedule for estates and trusts under which the maximum tax benefit of the graduated rate structure applicable to estates or trusts was reduced substantially to slightly more than $600 per year for a trust or estate. (Because of indexing of the rate brackets, that benefit has increased to $845 per year per trust or estate.) The Congress determined that the insignificant potential tax reduction available through the transfer of property to trusts no longer warranted the complexity of the throwback rules and section 644.

Explanation of Provision

The Act generally exempts from the throwback rules amounts distributed by a domestic trust after the date of enactment. The throwback rules continue to apply with respect to (1) foreign trusts, (2) domestic trusts that were once treated as foreign trusts (except as provided in Treasury regulations), and (3) domestic trusts created before March 1, 1984, that would be treated as multiple trusts under sec. 643(f) of the Code.

The Act also provides that precontribution gain on property sold by a domestic trust no longer is subject to section 644 (i.e., taxed at the contributor's marginal tax rates).

Effective Date

The provision with respect to the throwback rules is effective for distributions made in taxable years beginning after the date of enactment (August 5, 1997). The modification to section 644 applies to sales or exchanges after the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $11 million per year in fiscal years 1999 through 2007.

8. Reduction in estate tax for certain land subject to permanent conservation easement (sec. 508 of the Act and sec. 2031 of the Code)

Present and Prior Law

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

The same definition of qualified conservation contributions also applies for purposes of determining whether such contributions qualify as charitable deductions for income tax purposes.

A donor making a qualified conservation contribution generally was not allowed to retain an interest in minerals which could be extracted or removed by any surface mining method. However, deductions for contributions of conservation interests satisfying all of the above requirements were permitted if two conditions were satisfied. First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976 (and remain so separated) and, second,

the probability of surface mining on the property with respect to which a contribution is made must have been so remote as to be negligible (sec. 170(h)(5)(B)).

Reasons for Change

The Congress believed that a reduction in estate taxes for land subject to a qualified conservation easement would ease existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes, and would thereby help to preserve environmentally significant land.

Explanation of Provision

Reduction in estate taxes for certain land subject to permanent conservation easement

The Act allows an executor to elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. For example, if a $1 million property is subject to an outstanding acquisition indebtedness balance of $100,000, it is treated in the same manner as a $900,000 property that is not debt-financed.

The exclusion amount is calculated based on the value of the property includible in the gross estate, reduced by the amount of any deduction taken under section 2055(f) with respect to such land. In general, this value will be equal to the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights may be deferred for up to two years, or until the disposition of the property, whichever is earlier. For this purpose, retained development rights are any rights retained to use the land for any com-

mercial purpose which is not subordinate to and directly supportive of farming purposes, as defined in section 2032A(e)(5) (e.g., tree farming, ranching, viticulture, and the raising of other agricultural or horticultural commodities). De minimis commercial recreational activity that is consistent with the conservation purpose, such as the granting of hunting and fishing licenses, will not cause the property to fail to qualify for the exclusion. It is anticipated that the Secretary of the Treasury will provide guidance as to the definition of "de minimis" activities.

With respect to land held by a partnership, corporation, or trust, a look-through rule applies to the extent that the decedent owns (directly or indirectly) at least 30 percent of the entity involved.

Maximum benefit allowed

The 40-percent estate tax exclusion for land subject to a qualified conservation easement is limited to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter.

If the value of the conservation easement is less than 30 percent of (1) the value of the land without the easement, reduced by (2) the value of any retained development rights, then the exclusion percentage is reduced. The reduction in the exclusion percentage is equal to two percentage points for each point that the above ratio falls below 30 percent. Thus, for example, if the value of the easement is 25 percent of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is 30 percent (i.e., the 40 percent amount is reduced by twice the difference between 30 percent and 25 percent). Under this calculation, if the value of the easement is 10 percent or less of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is equal to zero.

Treatment of land subject to a conservation easement for purposes of special-use valuation

The granting of a qualified conservation easement (as defined above) is not treated as a disposition triggering the recapture provisions of section 2032A. In addition, the existence of a qualified conservation easement does not prevent such property from subsequently qualifying for special-use valuation treatment under section 2032A.

Retained mineral interests

The Act also allows a charitable deduction (for income tax purposes or estate tax purposes) to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible." Prior law provided for a charitable deduction in such a case if the mineral interests were separated from the land prior to June 13, 1976. The provision allows such a charitable deduction to be taken regardless of when the mineral interests were separated.

Effective Date

The estate tax exclusion applies to decedents dying after December 31, 1997. The rules with respect to the treatment of conservation easements under section 2032A and with respect to retained mineral interests are effective for easements granted after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $7 million in 1999, $15 million in 2000, $25 million in 2001, $35 million in 2002, $48 million in 2003, $51 million in 2004, $56 million in 2005, $60 million in 2006, and $64 million in 2007.

B. Generation-Skipping Tax Provision

1. Modification of generation-skipping transfer tax for transfers to individuals with deceased parents (sec. 511 of the Act and sec. 2651 of the Code)

Present and Prior Law

Under the "predeceased parent exception," a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer ("GST") tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). Under prior law, this "predeceased parent exception" to the GST tax was not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Reasons for Change

The Congress believed that a transfer to a collateral relative whose parent is dead should qualify for the predeceased parent exception in situations where the transferor decedent has no lineal heirs, because no motive or opportunity to avoid transfer tax exists. For similar reasons, the Congress believed that transfers to trusts should be permitted to qualify for the predeceased parent exclusion where the parent of the beneficiary is dead at the time that the transfer is first subject to estate or gift tax. The Congress also understood that this treatment would remove a present law impediment to the establishment of charitable lead trusts.

Explanation of Provision

The Act extends the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception applies to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the Act extends the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of

the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) is deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

Effective Date

The provision is effective for generation skipping transfers occurring after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million per year in 1999-2003, $5 million per year in 2004–2006, and $6 million in 2007.

TITLE VI. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

A. Research Tax Credit (sec. 601 of the Act and sec. 41 of the Code)

Prior Law

General rule

Prior to May 31, 1997, section 41 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 generally did not apply to amounts paid or incurred after May 31, 1997.[100]

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[101]

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[100] When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995. The credit later was extended for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

[101] The Small Business Job Protection Act of 1996 expanded 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.

A special rule (enacted in 1993) is 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 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-based 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-based 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)).

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, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer (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 of 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)).

Alternative incremental research credit regime

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed 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.

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").[102]

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

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

Relation to deduction

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

Reasons for Change

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

[102] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 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 general rule under section 41(b)(3) 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 research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

search activities, it is appropriate to reinstate the research tax credit.

Explanation of Provision

The research tax credit is extended for 13 months—i.e., generally for the period June 1, 1997, through June 30, 1998.

Under the provision, taxpayers are permitted to elect the alternative incremental research credit regime under section 41(c)(4) for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Effective Date

Extension of the research credit is effective for qualified research expenditures paid or incurred during the period June 1, 1997, through June 30, 1998. A special rule provides that, notwithstanding the general termination date for the research credit of June 30, 1998, if a taxpayer elects to be subject to the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, the alternative incremental research credit will be available during the entire 24-month period beginning with the first month of such taxable year—i.e., the equivalent of the 11-month extension provided for by the Small Business Job Protection Act of 1996 *plus* an additional 13-month extension provided for by the conference agreement. However, to prevent taxpayers from effectively obtaining more than 24-months of research credits from the Small Business Job Protection Act of 1996 and this bill, the 24-month period for taxpayers electing the alternative incremental research credit regime is reduced by the number of months (if any) after June 1996 with respect to which the taxpayer claimed research credit amounts under the regular, 20-percent research credit rules.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $161 million in 1997, $820 million in 1998, $639 million in 1999, $294 million in 2000, $204 million in 2001, $123 million in 2002, and $33 million in 2003.

B. Contributions of Stock to Private Foundations (sec. 602 of the 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.[103] 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

[103] 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)).

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.[104]

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 are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to May 31, 1997.[105] Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation do not exceed 10 percent in value of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that are made by any member of the individual's family.

Reasons for Change

The Congress believed that, to encourage donations to charitable private foundations, it is appropriate to extend the rule that allows a fair market value deduction for certain gifts of appreciated stock to private foundations.

Explanation of Provision

The Act provides that the special rule contained in section 170(e)(5) is extended for the period June 1, 1997, through June 30, 1998.

Effective Date

The provision is effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through June 30, 1998.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $99 million in 1998, $9 million in 1999, and $4 million in 2000.

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[104] 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 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).

[105] The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

C. Work Opportunity Tax Credit (sec. 603 of the Act and sec. 51 of the Code)

Present Law

In general

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. Generally, 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.

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.

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 yet 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 em-

ployer 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 yet 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.

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).

Expiration date

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

Reasons for Change

The Congress believed that a short-term extension of the work opportunity tax credit program with modifications will provide the Congress and the Treasury and Labor Departments an opportunity to assess fully the operation and effectiveness of the credit as a hiring incentive. The Act also will extend application of the credit to a larger group of eligible individuals pending that evaluation.

Explanation of Provision

Extension

The work opportunity tax credit is extended for nine months (through June 30, 1998).

Targeted categories

Eligibility is extended to: (1) members of families receiving AFDC benefits for any nine months during the eighteen month period ending on the hiring date, and (2) individuals receiving supplemental security income ("SSI") benefits under Title XVI of the Social Security Act.

Minimum employment period

The minimum employment period is reduced from 400 to 120 hours.

Credit percentage

The Act provides a two-tier credit. The credit percentage is 25 percent for employment of less than 400 hours and 40 percent for employment of 400 or more hours. To illustrate, assume that two eligible individuals (A and B) begin work for their employer before July 1, 1998 for a $6 hourly wage. Assume, further that A completes 300 hours of employment and B completes 500 hours of em-

ployment. The employer will be entitled to a credit of $450 for A (25 percent of $1,800) and $1,200 for B (40 percent of $3,000).

Effective Date

Generally, the provision is effective for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer after September 30, 1997, and before July 1, 1998.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $140 million in 1998, $131 million in 1999, $73 million in 2000, $28 million in 2001, $11 million in 2002, and $2 million in 2003.[106]

D. Orphan Drug Tax Credit (sec. 604 of the Act and sec. 45C of the Code)

Prior Law

Prior to May 31, 1997, 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).

As with other general business credits (sec. 38), taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit expired and did not apply to expenses paid or incurred after May 31, 1997.[107]

Reasons for Change

The Congress believed it appropriate to reinstate the orphan drug tax credit.

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[106] The estimate includes interaction with the welfare-to-work tax credit; see explanation of section 801 of the Act.

[107] The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired after December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

Explanation of Provision

The orphan drug tax credit provided for by section 45C is permanently extended.

Effective Date

The provision is effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $29 million in 1998, $28 million in 1999, $30 million in 2000, $32 million in 2001, $34 million in 2002, $35 million in 2003, $37 million in 2004, $39 million in 2005, $40 million in 2006, and $42 million in 2007.

TITLE VII. DISTRICT OF COLUMBIA TAX INCENTIVES

(sec. 701 of the Act and new secs. 1400-1400C of the Code)

Present and Prior Law

Empowerment zones and enterprise communities

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. The 1997 Act provides for the designation of 22 additional empowerment zones.[108] Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations. Portions of the District of Columbia were designated as an enterprise community in 1994.

The following tax incentives are available for certain businesses located in empowerment zones designated under OBRA 1993: (1) an annual 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property placed in service by an enterprise zone business; and (3) special tax-exempt financing for certain zone facilities. These incentives are described under Act secs. 951–956, below.

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the empowerment zones. In addition, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities. Under the Act, the so-called "brownfields" tax incentive (described in Act sec. 941, below) that allows taxpayers to expense certain environmental remediation expenditures is available in enterprise communities, as well as in empowerment zones. In addition, certain schools located in empowerment zones or enterprise communities may be able to benefit from the issuance of so-called "zone academy bonds" (described under Act sec. 226, above) under the Act.

The tax incentives for empowerment zones and enterprise communities generally are available during the 10-year period that the designation remains in effect.

Taxation of capital gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain generally is taxed at the same rate as ordinary income, except that, for individuals, the maximum rate of tax is limited to 20 per-

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[108] The Act authorizes the designation of two additional urban empowerment zones that would be eligible for the tax incentives available in empowerment zones designated under OBRA 1993. The Act also authorizes the designation of an additional 20 empowerment zones. Within these additional empowerment zones, qualified enterprise zone businesses are eligible to receive up to $20,000 of additional section 179 expensing and to utilize special tax-exempt financing benefits. However, such businesses are *not* eligible to receive the present-law wage credit. The 20 additional empowerment zones are described in detail in Act secs. 951–956, below.

cent of the net capital gain.[109] Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year. The maximum 20-percent rate generally applies to capital assets held for more than 18 months.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

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

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method. Under the Act, gain from the sale of depreciable real property, to the extent that it is "unrecaptured section 1250 gain," is subject to a maximum rate of 25 percent.

Reasons for Change

The Congress believed that the District of Columbia faces two key problems—inability to attract and retain a stable residential base and insufficient economic activity. To this end, the Congress provided certain tax incentives to attract new homeowners to the District and to encourage economic development in those areas of the District where development has been inadequate.

Explanation of Provisions

Designation of D.C. Enterprise Zone

The Act designates certain economically depressed census tracts within the District of Columbia as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Enterprise Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., por-

[109] The Act generally reduces the maximum rate of tax on the net capital gain of an individual from 28 percent to 20 percent, and makes certain other modifications to the maximum capital gains rates applicable to certain assets. These modifications are described in detail under Act sec. 311, above. In addition, Code section 1202 provides a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years. However, the lower rates provided by the Act do not apply to the includable portion of the gain from the qualifying sale of small business stock. (See Act sec. 313, above, for a detailed description of the modifications made by the Act to the small business stock rules.)

tions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District) and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent.[110] The D.C. Enterprise Zone designation generally will remain in effect for five years for the period from January 1, 1998, through December 31, 2002.[111]

Empowerment zone wage credit, expensing, and tax-exempt financing

In general

The following tax incentives that are available under present law in certain empowerment zones are available in the D.C. Enterprise Zone (modified as described below): (1) a 20-percent wage credit for the first $15,000 of wages paid to District residents who work in the D.C. Enterprise Zone; (2) an additional $20,000 of expensing under Code section 179 for qualified zone property; and (3) special tax-exempt financing for certain zone facilities. In addition, Federal tax incentives that are generally available in designated empowerment zones also are available in the D.C. Enterprise Zone (e.g., expensing of certain environmental remediation expenditures (the so-called "brownfields" provision), and the tax credit for holders of qualified "zone academy bonds").[112]

D.C. employer wage credit

A 20-percent credit against income tax liability is available to all employers for the first $15,000 of qualified wages paid to each employee who (1) is a District resident (i.e., his or her principal place of abode is within the District), and (2) performs substantially all employment services within the D.C. Zone in a trade or business of the employer.[113] The D.C. wage credit rate remains at 20 percent for the D.C. Enterprise Zone for the period 1998 through 2002.[114]

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[110] A technical correction is necessary to clarify that the determination of whether a census tract in the District of Columbia satisfies the applicable poverty criteria for inclusion in the D.C. Enterprise Zone for purposes of the wage credit, expensing, and special tax-exempt financing incentives (poverty rate of not less than 20 percent) or for purposes of the zero-percent capital gains rate (poverty rate of not less than 10 percent), is based on 1990 decennial census data. A provision to this effect is included in Title VI (sec. 607) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997. This technical correction would clarify that data from the 2000 decennial census will not result in the expansion or other reconfiguration of the D.C. Enterprise Zone.

[111] The status of certain census tracts within the District as an enterprise community designated under section 1391 also terminates on December 31, 2002.

[112] Similarly, one category of targeted individuals for purposes of the work opportunity tax credit is "high risk youth," defined as individuals certified by the designated local agency as being 18–24 years old, and having a principal place of abode in an empowerment zone or enterprise community. Accordingly, individuals between the ages of 18 and 24 who live in the portions of the District that are designated as the D.C. Enterprise Zone may qualify as members of a targeted group for purposes of the work opportunity tax credit.

[113] Proposed Treasury regulations provide that an employer may use either each pay period or the entire calendar year as the relevant period in determining whether a particular employee satisfies the "location-of-services" requirement. For each taxable year, the employer must use the same method for all its employees. Prop. Treas. Reg. sec. 1.1396–1. Under the proposed regulations, an employee would not satisfy the "location of services" requirement during the applicable period (either the pay period or the calendar year) unless substantially all of the services performed by the employee for the employer during that period are performed within the zone in a trade or business of the employer. Prop. Treas. Reg. sec. 1.1396–1(b)(1)(ii) and Prop. Treas. Reg. sec. 1.1396–1(b)(2)(ii).

[114] Thus, the D.C. wage credit does not phase down to 15 percent in the year 2002 as does the empowerment zone wage credit under present-law section 1396(b).

The maximum D.C. wage credit per qualified employee is $3,000 per year (20 percent of $15,000). Wages paid to a qualified employee continue to be eligible for the D.C. wage credit if the employee earns more than $15,000, although only the first $15,000 of wages will be eligible for the D.C. wage credit.[115] The D.C. wage credit is available with respect to a qualified employee, regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the D.C. wage credit, regardless of whether the employer meets the definition of a "D.C. Zone business" (which applies for the increased section 179 expensing, the tax-exempt financing, and the zero-percent capital gains rate provisions, described below).

Qualified wages include the first $15,000 of "wages," defined to include (1) salary and wages as generally defined for FUTA purposes, and (2) certain training and educational expenses paid on behalf of a qualified employee, provided that (a) the expenses are paid to an unrelated third party and are excludable from gross income of the employee under section 127, or (b) in the case of an employee under age 19, the expenses are incurred by the employer in operating a youth training program in conjunction with local education officials.

The D.C. wage credit is allowed with respect to full-time and part-time employees. However, the employee must be employed by the employer for a minimum period of at least 90 days. Wages are not eligible for the D.C. wage credit if paid to certain relatives of the employer or, if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business. In addition, wages are not eligible for the D.C. wage credit if paid to a person who owns more than five percent of the stock (or capital or profits interests) of the employer. Finally, the wage credit is not available with respect to any individual employed at any facility described in present-law section 144(c)(6)(B) (i.e., a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises). In addition, the 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)), but only if, as of the close of the preceding taxable year, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of assets of the farm exceed $500,000.[116]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of D.C. wage credit claimed for that taxable year.[117] Wages are not to be taken into account for purposes of the D.C. wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.[118] In addition, the $15,000 cap is

[115] To prevent avoidance of the $15,000 limit, all employers of a controlled group of corporations (or partnerships or proprietorships under common control) will be treated as a single employer.

[116] Code secs. 1396(d)(2)(D) and (E).

[117] Code sec. 280C(a).

[118] Code sec. 1396(c)(3)(A) and Code sec. 51A(d)(2).

reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[119] The D.C. wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[120]

The wage credit is effective for wages paid (or incurred) to a qualified individual for services performed after December 31, 1997, and before January 1, 2003.

Increased expensing under Code section 179

For a "qualified D.C. Zone business" (defined below), the expensing allowance for certain depreciable business property provided under section 179 is increased by the lesser of: (1) $20,000 or (2) the cost of section 179 property that is "qualified zone property" and that is placed in service during the taxable year.

To qualify for the increased expensing, property must be both section 179 property and "qualified zone property." Section 179 property generally is depreciable tangible personal property as well as certain other property. Buildings and their structural components are not section 179 property. "Qualified zone property" is depreciable tangible property that satisfies three tests: (1) it must be acquired by purchase after December 31, 1997; (2) the original use of the property in the D.C. Zone must commence with the taxpayer (however, used property that has been used elsewhere may qualify); and (3) substantially all of the use of the property must be in the active conduct of a trade or business by the taxpayer within the D.C. Zone. A special rule provides that, in the case of property that is "substantially renovated" by the taxpayer, such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the D.C. Enterprise Zone commence with the taxpayer. Rather, substantially all of the use of such property during substantially all of the taxpayer's holding period (after it has been substantially renovated) must be in the active conduct of a qualified D.C. Zone business of the taxpayer in the D.C. Enterprise Zone. For this purpose, property is treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) $5,000.

As under present law, the section 179 expensing allowance is phased out for certain taxpayers with investment in qualified property during the taxable year in excess of $200,000. However, the present-law phase-out range is applied by taking into account only one-half of the cost of qualified zone property that is section 179 property. In applying the section 179 phaseout, the cost of section 179 property that is not qualified zone property is not reduced. The amount permitted to be expensed and deducted under Code section 179 may not exceed the taxable income derived from the active conduct of a trade or business.

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[119] Code sec. 1396(c)(3)(B) and Code sec. 51A(d)(2).
[120] Code sec. 38(c)(2).

In general, all other provisions of present-law section 179 apply to the increased expensing for qualified D.C. Zone businesses. Thus, all component members of a controlled group are treated as one taxpayer for purposes of the expensing allowance and the application of the phaseout range (sec. 179(d)(6)). The limitations apply at both the partnership (and S corporation) and partner (and shareholder) levels. The increased expensing allowance is allowed for purposes of the alternative minimum tax (i.e., it is not treated as an adjustment for purposes of the alternative minimum tax). The section 179 expensing deduction may be recaptured if the property is not used predominantly in a qualified D.C. Zone business (under rules similar to present-law section 179(d)(10)).

Accordingly, qualified D.C. Zone businesses with a sufficiently small amount of annual investment may elect to deduct currently (as opposed to depreciate over time) up to $38,500 in 1998 of the cost of qualifying property placed in service for the taxable year. The maximum will increase as the base amount permitted to be expensed under Code section 179 increases each year, up to a maximum amount of $44,000 in 2001 and 2002.

The increased expensing under Code section 179 is effective for qualified D.C. Zone property placed in service periods beginning after December 31, 1997, and before January 1, 2003.

Qualified D.C. Zone business.—For purposes of the increased expensing under Code section 179 (as well as generally for purposes of the tax-exempt financing provisions and the zero-percent capital gains rate described below), a qualified D.C. Zone business generally is defined in the same manner as is an "enterprise zone business" under section 1397B.[121] However, the Act eliminates the requirement that at least 35 percent of the employees of a qualified D.C. Zone business must be residents of the D.C. Zone.[122]

Accordingly, for purposes of the increased expensing under section 179, a corporation or partnership is a qualified D.C. Zone business if: (1) the sole trade or business[123] of the corporation or partnership is the active conduct of a "qualified business" (defined below) within the D.C. Zone;[124] (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within the D.C. Zone;[125] (3) a substantial por-

[121] The requirements of an "enterprise zone business" under section 1397B were developed as part of OBRA 1993 in the context of authorizing the designation of nine unspecified empowerment zones located throughout the nation. Congress may wish to reconsider the applicability of certain of these requirements in defining a qualified D.C. Zone business given the nature of the District's economy and the type of economic activity that Congress intended to encourage.

[122] Section 1400(e) eliminates this requirement contained in section 1397B(b)(6) with respect to corporations and partnerships and in section 1397B(c)(5) with respect to proprietorships.

[123] A technical correction may be necessary to clarify that, for purposes of this provision, as well as for purposes of defining a "qualified business", the term "trade or business" encompasses activities carried out on a not-for-profit, as well as on a for-profit basis. For example, a trade association could be a qualified D.C. Zone business if it satisfies all of the requirements enumerated above.

[124] This requirement does not apply to a business carried on by an individual as a proprietorship.

[125] Regulations issued under section 1394 give an example of a business that would satisfy this test. The regulations describe a mail order clothing business which is located in an empowerment zone. The business purchases its supplies from suppliers located both within and outside of the zone and expects that orders will be received both from customers who will reside or work within the zone and from others outside of the zone. All orders are received and filled at, and are shipped from, the clothing business located in the zone. Under the regulations, this clothing business meets the requirement that at least 80 percent (as required under prior law)

tion of the use of the entity's tangible property (whether owned or leased) is within the D.C. Zone; (4) a substantial portion of the entity's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed for such entity by its employees are performed within the D.C. Zone; and (6) less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to (a) certain financial property,[126] or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business. Similar rules apply to a qualified business carried on by an individual as a proprietorship.[127]

In general, a "qualified business" means any trade or business. However, a "qualified business" does not include any trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, a qualified business does not include any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, liquor store, or certain large farms (so-called "excluded businesses"). The rental of residential real estate is not a qualified business. The rental of commercial real estate is a qualified business only if at least 50 percent of the gross rental income from the real property is from qualified D.C. Zone businesses. The rental of tangible personal property to others also is not a qualified business unless at least 50 percent of the rental of such property is by qualified D.C. Zone businesses or by residents of the D.C. Zone.

A special rule applies to businesses located on contiguous real property that straddles census tract lines. If the amount of real property located within the D.C. Zone is substantial compared to the amount of real property that is not within the D.C. Zone, then all of the services performed by employees, all business activities, all tangible property and all intangible property of the business entity or proprietorship that occur in or is located on the real property is treated as occurring or situated in the D.C. Zone.[128]

Activities of legally separate (even if related) parties are not aggregated for purposes of determining whether an entity qualifies as a D.C. Zone business.

Tax-exempt financing

A qualified D.C. Zone business (as defined below) is permitted to borrow proceeds from the issuance of qualified enterprise zone facility bonds (as defined in section 1394) by the District of Colum-

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of its gross income is derived from the active conduct of business within the zone. Treas. Reg. sec. 1.1394–1(p), Example (3).

[126] Nonqualified financial property is defined in Code section 1397B(e) to mean debt, stock, partnership interest, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property. The term does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory property.

[127] For purposes of determining status as a qualified D.C. Zone business, limited liability companies will be characterized as corporations or partnerships in accordance with the so-called "check-the-box" regulations (Treas. Reg. sec. 301.7701–3). A single member limited liability company that is disregarded for Federal income tax purposes under the check-the-box regulations would be treated as a proprietorship or branch for purposes of determining its status as a qualified D.C. Zone business.

[128] Code section 1397B(f).

bia.[129] Such bonds are subject to the District's annual private activity bond volume limitation of $150 million.[130]

Generally, qualified enterprise zone facility bonds for the District are bonds 95 percent or more of the net proceeds of which are used to finance: (1) qualified D.C. Zone property the principal user[131] of which is a qualified D.C. Zone business, and (2) functionally related and subordinate land located in the D.C. Enterprise Zone.

"Qualified D.C. Zone property" for these purposes generally has the same definition as "qualified zone property" for purposes of the increased expensing under section 179. Thus, it is depreciable tangible property that satisfies three tests: (1) it must be acquired by purchase after December 31, 1997; (2) the original use of the property in the D.C. Zone must commence with the taxpayer (however, property that has been used elsewhere may qualify);[132] and (3) substantially all of the use of the property must be in the active conduct of a trade or business by the taxpayer within the D.C. Zone. A special rule provides that, in the case of business property that is "substantially renovated," such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the D.C. Enterprise Zone commence with the taxpayer. Solely for purposes of the tax-exempt financing provisions, property is treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to 15 percent of the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) $5,000.[133]

Similarly, the term "D.C. Zone business" generally is defined as for purposes of the increased expensing under section 179. However, a qualified D.C. Zone business for purposes of the tax-exempt financing provisions includes a business located in the D.C. Zone that would qualify as a D.C. Zone business if it were separately incorporated.[134] In addition, under a special rule applicable only for purposes of the tax-exempt financing rules, a business is not required to satisfy the requirements applicable to a D.C. Zone business until the end of a startup period if, at the beginning of the startup period, there is a reasonable expectation that the business will be a qualified D.C. Zone business at the end of the startup period and the business makes bona fide efforts to be such a business. With respect to each property financed by a bond issue, the

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[129] Portions of the District of Columbia were designated as an enterprise community under section 1391 in 1994. Accordingly, the District was entitled to issue tax-exempt enterprise zone facility bonds under section 1394. In fact, however, the District did not issue any such bonds.

[130] The exception to the volume cap that is available with respect to new empowerment zone facility bonds (described in section 1394(f)) does not apply to D.C. enterprise zone facility bonds.

[131] In general, the term "principal user" means the owner of the financed property. However, in the case of rental property, if an owner of real property financed with enterprise zone facility bonds is not an enterprise zone business, but the rental of the property is a qualified business (i.e., 50 percent of the gross rental income is derived from enterprise zone businesses), then the term "principal user" for purposes of sections 1394 (b) and (e) means the lessee(s). Treas. Reg. sec. 1.1394–1(j). See also Treas. Reg. sec. 1.1394–1(p), Example (8).

[132] Treas. Reg. sec. 1.1394–1(h) defines the term "original use" to mean the first use to which the property is put within the zone. Under a special rule, if property is vacant for at least a one-year period including the date of the zone designation, then use prior to that period is disregarded for purposes of determining original use.

[133] Code section 1394(b)(2)(B).

[134] For example, an establishment that is part of a national chain could qualify as a D.C. Zone business for purposes of the tax-exempt financing incentive, provided that such establishment would satisfy the definition of a D.C. Zone business if it were separately incorporated.

startup period ends at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). In addition, if a business satisfies certain requirements applicable to a qualified D.C. Zone business for a three-year testing period following the end of the start-up period and thereafter continues to satisfy certain business requirements,[135] then it will be treated as a qualified D.C. Zone business for all years after the testing period irrespective of whether it satisfies all of the requirements of a qualified D.C. Zone business.[136]

The aggregate face amount of all outstanding qualified enterprise zone bonds per qualified D.C. Zone business may not exceed $15 million. However, the $15 million-per-D.C. Zone business requirement should not limit issuance of a single issue of bonds (in excess of $15 million) for more than one qualified facility, provided that the $15 million limit is satisfied with respect to each qualified D.C. Zone business. In addition, total outstanding qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all empowerment zones and enterprise communities, including the D.C. Enterprise Zone. For purposes of these determinations, the aggregate amount of outstanding enterprise zone facility bonds allocable to any business shall be determined under rules similar to rules contained in section 144(a)(10).

Qualified enterprise zone facility bonds are exempt from the general restrictions on financing the acquisition of existing property set forth in section 147(d). Additionally, these bonds are exempted from the general restriction in section 147(c)(1)(A) on financing land (or an interest therein) with 25 percent or more of the net proceeds of a bond issue. Unless otherwise noted, all other tax-exempt bond rules relating to exempt facility bonds (including the restrictions on bank deductibility of interest allocable to tax-exempt bonds) apply to qualified enterprise zone facility bonds.

Certain so-called "change-in-use" rules apply to qualified enterprise zone facility bonds. Accordingly, interest on all bond-financed loans to a business that no longer qualifies as a D.C. Zone business, or on loans to finance property that ceases to be used by the business in the D.C. Zone, becomes nondeductible, effective from the first day of the taxable year in which the disqualification or cessation of use occurs. This penalty is waived if: (1) the issuer and principal user in good faith attempted to meet these requirements and (2) any failure to meet such requirements is corrected within a reasonable period after such failure is first discovered. This pen-

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[135] To be eligible for this special rule after the end of the 3-year testing period, a business must remain a trade or business that does not (1) consist predominantly of the development or holding of intangibles for sale or license, (2) involve the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or liquor store, and (3) have as its principal activity farming with respect to certain large farms.

[136] Section 1394(b)(3)(B)(iii) waives all of the requirements of an enterprise zone business described in sections 1397B(b) or (c) for certain businesses after the prescribed testing period *except* the requirement that at least 35 percent of the employees of such business be residents of the empowerment zone or enterprise community. However, the 35-percent zone resident requirement does not apply with respect to qualified D.C. Zone businesses (sec. 1400(e)). Accordingly, a technical correction is necessary to clarify that qualified D.C. Zone businesses that take advantage of the special tax-exempt financing incentives do not become subject to a 35-percent zone resident requirement after the close of the testing period.

alty does not apply solely by reason of the termination or revocation of the District's designation as the D.C. Enterprise Zone. The good faith rule described above also applies to certain other requirements of qualified enterprise zone facility bonds.

These bonds may only be issued while the D.C. Enterprise Zone designation is in effect. Thus, the special tax-exempt bond provisions apply to bonds issued after December 31, 1997, and prior to January 1, 2003.

Zero-percent capital gains rate

The Act provides a zero-percent capital gains rate for capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. In general, qualified "D.C. Zone assets" mean stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

For purposes of the zero-percent capital gains rate, the definition of qualified D.C. Zone business generally is the same as the definition applicable for purposes of the increased expensing under section 179, described above.[137] However, solely for purposes of the zero-percent capital gains rate, a qualified D.C. Zone business must derive at least 80 percent (as opposed to 50 percent) of its total gross income from the active conduct of a qualified business within the D.C. Enterprise Zone.

"D.C. Zone business stock" is stock in a domestic corporation originally issued after December 31, 1997, that, at the time of issuance[138] and during substantially all of the taxpayer's holding period, was a qualified D.C. Zone business, provided that such stock was acquired by the taxpayer on original issue from the corporation solely in exchange for cash before January 1, 2003.[139] A "D.C. Zone partnership interest" is a domestic partnership interest originally issued after December 31, 1997, that is acquired by the taxpayer from the partnership solely in exchange for cash before January 1, 2003, provided that, at the time such interest was acquired[140] and during substantially all of the taxpayer's holding period, the partnership was a qualified D.C. Zone business.

Finally, "D.C. Zone business property" is tangible property[141] acquired by the taxpayer by purchase (within the meaning of present law section 179(d)(2)) after December 31, 1997, and before January

[137] A technical correction to section 1400B(c) is necessary to clarify that a proprietorship can constitute a D.C. Zone business for purposes of the zero-percent capital gains rate.

[138] In the case of a new corporation, it is sufficient if the corporation is being organized for purposes of being a qualified D.C. Zone business.

[139] D.C. Zone business stock does not include any stock acquired from a corporation which made substantial stock redemption of distribution (without a bona fide business purpose therefor) in an attempt to avoid the purposes of the provision. A similar rule applies with respect to D.C. Zone partnership interests.

[140] In the case of a new partnership, it is sufficient if the partnership is being formed for purposes of being a qualified D.C. Zone business.

[141] D.C. Zone business property is limited to tangible property. Thus, for example, D.C. Zone businesses that are qualified proprietorships cannot claim the zero-percent rate on capital gain from the sale of any intangible property. Similarly, corporations or partnerships cannot claim the zero-percent rate on capital gain from the direct sale of intangible property. However, the zero-percent rate does apply to qualified gain from the sale of D.C. Zone business stock or a D.C. Zone partnership interest that is attributable to the value of intangible assets held by the entity, provided such assets are an integral part of a D.C. Zone business.

1, 2003, provided that the original use of such property in the D.C. Enterprise Zone commences with the taxpayer and substantially all of the use of such property during substantially all of the taxpayer's holding period was in a qualified D.C. Zone business of the taxpayer. A special rule provides that, in the case of a building that is "substantially renovated" (including any land on which such building is located), such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the D.C. Enterprise Zone commence with the taxpayer. Rather, substantially all of the use of such property during substantially all of the taxpayer's holding period (after it has been substantially renovated) must be in a qualified D.C. Zone business of the taxpayer. For these purposes, property is treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) $5,000.

In addition, qualified D.C. Zone assets include property that was a qualified D.C. Zone asset in the hands of a prior owner,[142] provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. Zone business, or (2) the property is an ownership interest in a qualified D.C. Zone business.[143]

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or (2) property used in the trade or business as defined in section 1231(b). Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, *provided that* such real property or intangible asset is an integral part of a qualified D.C. Zone business.[144] However, no gain attributable to periods before January 1, 1998, and after December 31, 2007, is qualified capital gain. In addition, no gain that is attributable, directly or indirectly, to a transaction with a related person is eligible for the zero-percent rate.

The Act provides that property that ceases to be a qualified D.C. Zone asset because the property is no longer used in (or no longer represents an ownership interest in) a qualified D.C. Zone business after the five-year period beginning on the date the taxpayer acquired such property continues to be treated as a qualified D.C. Zone asset. Under this rule, the amount of gain eligible for the zero-percent capital gains rate cannot exceed the amount which would be qualified capital gain had the property been sold on the date of such cessation.

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[142] A technical correction is necessary to clarify that there is no requirement that D.C. Zone business property be acquired by a subsequent purchaser prior to January 1, 2003, to be eligible for this special rule.

[143] The termination of the D.C. Zone designation will not, by itself, result in property failing to be treated as a qualified D.C. Zone asset. However, capital gain eligible for the zero-percent capital gains rate does not include any gain attributable to periods after December 31, 2007.

[144] However, as described above, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

Under a special rule, the zero-percent capital gains rate applies to any amount that is included in a taxpayer's gross income by reason of holding an interest in a pass-thru entity (i.e., a partnership, S corporation, regulated investment company, and common trust fund) if the amount is attributable to qualified capital gain recognized on the sale or exchange of a qualified D.C. Zone asset by the pass-thru entity. This flow-through of the zero-percent capital gains rate applies only to qualified D.C. Zone assets that were held by the pass-thru entity for more than five years and were acquired and disposed of by the pass-thru entity while the taxpayer held an interest in the pass-thru entity. In addition, the amount of gain to which this rule applies is limited based on the interest of the taxpayer in the pass-thru entity on the date that the qualified D.C. Zone asset was acquired.[145]

The Act also provides that in the case of a transfer of a qualified D.C. Zone asset by gift, at death, or from a partnership to a partner that held an interest in the partnership at the time that the qualified D.C. Zone asset was acquired, (1) the transferee is to be treated as having acquired the asset in the same manner as the transferor, and (2) the transferee's holding period includes that of the transferor. In addition, rules similar to those contained in section 1202(i)(2) regarding treatment of contributions to capital after the original issuance date and section 1202(j) regarding treatment of certain short positions apply.

First-time home buyer tax credit

The Act provides first-time homebuyers of a principal residence in the District a tax credit of up to $5,000 of the amount of the purchase price.[146] The $5,000 maximum credit amount applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers). The Secretary of Treasury may prescribe regulations allocating the credit among unmarried purchasers of a residence.[147]

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) did not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.[148]

A taxpayer will be treated as a first-time homebuyer with respect to only one residence—i.e., the credit may be claimed one time

[145] Code secs. 1400B(f) and 1202(g). The legislative history of the Act incorrectly describes the operation of this special rule.

[146] A technical correction is necessary to clarify that the term "purchase price" means the adjusted basis of the principal residence on the date the residence is purchased. A newly constructed residence is treated as purchased by the taxpayer on the date the taxpayer first occupies such residence. Provisions to this effect are included in Title VI (sec. 607) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[147] The provision of the Act that excludes sales of certain personal residences from the real estate transaction reporting requirement (see Act sec. 312, above) may not apply to sales of personal residences in the District of Columbia. In this regard, the Congress anticipated that the Secretary of Treasury will require such information as may be necessary to verify eligibility for the D.C. first-time homebuyer credit.

[148] A technical correction is required to clarify the statute in this regard. A provision to this effect is included in Title VI (sec. 607) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

only. The credit is available with respect to purchases of existing property as well as new construction. A taxpayer's basis in a property is reduced by the amount of any homebuyer tax credit claimed with respect to such property.

The first-time homebuyer credit is a nonrefundable personal credit that is claimed after the credits described in Code sections 25 (credit for interest on certain home mortgages) and 23 (adoption credit).[149] The credit cannot be used to offset an alternative minimum tax liability. Any excess credit may be carried forward indefinitely to succeeding taxable years.

The first-time homebuyer credit is available only for property purchased after August 4, 1997, and before January 1, 2001. Thus, the credit is available to first-time home purchasers who acquire title to a qualifying principal residence on or after August 5, 1997, and on or before December 31, 2000, irrespective of the date the purchase contract was entered into.[150]

Effective Date

The D.C. wage credit is effective for wages paid (or incurred) to a qualified individual for services performed after December 31, 1997, and before January 1, 2003. The increased expensing under Code section 179 is effective for qualified D.C. Zone property placed in service in periods beginning after December 31, 1997, and before January 1, 2003. The special tax-exempt bond provisions apply to bonds issued after December 31, 1997, and prior to January 1, 2003. The zero-percent capital gains rate generally is effective for acquisitions of qualified D.C. Zone assets after December 31, 1997, and before January 1, 2003. The first-time homebuyer credit applies to purchases after the date of enactment (August 5, 1997) and before January 1, 2001.

Revenue Effect

The provision designating the D.C. Enterprise Zone (wage credit, increased expensing under section 179, and expanded tax-exempt financing) is estimated to reduce Federal fiscal year budget receipts by $71 million in 1998, $110 million in 1999, $113 million in 2000, $118 million in 2001, $127 million in 2002, and $45 million in 2003; to increase Federal fiscal year budget receipts by $3 million in 2004 and by $2 million in 2005; and to reduce Federal fiscal year budget receipts by less than $500,000 in 2006 and by $2 million in 2007.

The provision providing a zero-percent capital gains rate for certain property is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998, $5 million in 1999, $12 million in 2000, $21 million in 2001, $33 million in 2002, $48 million in 2003, $85 million in 2004, $90 million in 2005, $99 million in 2006, and $107 million in 2007.

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[149] A technical correction is required to clarify the statute in this regard. A provision to this effect is included in Title VI (sec. 607) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[150] A technical correction is required to clarify the statute in this regard. A provision to this effect is included in Title VI (sec. 607) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

The first-time homebuyer tax credit provision is estimated to reduce Federal fiscal year budget receipts by $10 million in 1998, $21 million in 1999, $27 million in 2000, $16 million in 2001, and by less than $500,000 per year in each of 2002 through 2007.

TITLE VIII. WELFARE-TO-WORK TAX CREDIT
(sec. 801 of the Act and new sec. 51A of the Code)

Present Law

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. Generally, 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 purposes of the work opportunity tax credit, the targeted groups for which the credit is available include: (1) families receiving Aid to Families with Dependent Children ("AFDC"); (2) qualified ex-felons; (3) high-risk youth; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; and (7) families receiving food stamps.

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.

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

Reasons for Change

One goal of the Personal Responsibility and Work Opportunity Reform Act of 1996 (Public Law 104–193) was to move individuals from welfare to work. The Congress believed that the welfare-to-work credit will provide to employers an additional incentive to hire these categories of individuals. This incentive is intended to ease the transition from welfare to work for the targeted categories of individuals by increasing access to employment. It is also intended to provide certain employee benefits to these individuals to encourage training, health coverage, dependent care and ultimately better job attachment.

Explanation of Provision

The Act provides to employers a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this

credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Effective Date

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before May 1, 1999.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $13 million in 1998, $31 million in 1999, $29 million in 2000, $15 million in 2001, $10 million in 2002, $4 million in 2003, $2 million in 2004, and $1 million in 2005.[151]

[151] The estimate includes interaction with the work opportunity tax credit; see explanation of section 603 of the Act.

TITLE IX. MISCELLANEOUS PROVISIONS

A. Excise Tax Provisions

1. Transfer of General Fund highway fuels tax revenues to the Highway Trust Fund (sec. 901 of the bill and sec. 9503 of the Code)

Present and Prior Law

Federal excise taxes are imposed on highway motor fuels to finance the Highway Trust Fund (currently, through September 30, 1999). Prior to October 1, 1997, the Highway Trust Fund motor fuels tax rates were 14 cents per gallon on highway gasoline and special motor fuels, 20 cents per gallon on highway diesel fuel, and 3 cents per gallon on diesel fuel used by intercity buses. Reduced tax rates apply to ethanol and methanol fuels. Excise taxes of 14 cents per gallon also apply to gasoline and special motor fuels used in motorboats, which goes first into the Highway Trust Fund. In addition, prior to October 1, 1997, a permanent General Fund tax of 4.3 cents per gallon was imposed on highway and other motor fuels (other than intercity bus gasoline and recreational motorboat diesel fuel, which were and are not subject to the tax, and rail diesel fuel, which paid a General Fund tax of 5.55 cents per gallon).

Under prior law, amounts equivalent to 2 cents per gallon of the Highway Trust Fund motor fuels tax revenues were credited to the Mass Transit Account of the Highway Trust Fund for capital-related expenditures on mass transit programs; the balance of the highway motor fuels tax revenues were and are credited to the Highway Account of the Trust Fund for highway-related programs generally.

Under prior law, transfers were made from the Highway Trust Fund of $1 million per fiscal year to the Land and Water Conservation Fund, plus up to $70 million per fiscal year (through September 30, 1997) to the Boat Safety Account of the Aquatic Resources Trust Fund of amounts equivalent to 11.5 cents per gallon from recreational motorboat gasoline and special motor fuels tax revenues. Any excess revenues attributable to the tax on motorboat fuels were and are transferred from the Highway Trust Fund to the Sport Fish Restoration Account in the Aquatic Resources Trust Fund.

Excise taxes imposed on gasoline, diesel and special motor fuels generally must be paid to the Treasury in semi-monthly deposits, which are credited to tax liability reported on quarterly excise tax returns. Subject to special rules for deposits attributable to taxes for the period September 16–26, deposits generally must be made 9 days after the end of each semi-monthly period (14 days for gasoline and diesel fuel taxes deposited by an independent refiner or small producer).

Reasons for Change

The Congress determined that, consistent with the historical user tax principle of the highway motor fuels taxes, the existing 4.3-cents-per-gallon General Fund excise tax on highway fuels should be transferred to the Highway Trust Fund. These monies

will be available for needed Highway Trust Fund programs in the future, to the extent consistent with overall budgetary spending levels.

Explanation of Provision

Transfer of revenues to Highway Trust Fund

The Act transfers the prior-law General Fund excise tax of 4.3 cents per gallon on all highway motor fuels to the Highway Trust Fund, beginning on October 1, 1997. Under the Act, 0.85 cents per gallon of the 4.3 cents per gallon motor fuels tax revenues are to be credited to the Mass Transit Account of the Highway Trust Fund (for a total of 2.85 cents per gallon).[152]

Deposit rules for highway motor fuels

The Act provides that the excise taxes on gasoline, diesel fuel, special motor fuels, and kerosene that otherwise would be required to be deposited with the Treasury after July 31, 1998, and before October 1, 1998, are not required to be deposited until October 5, 1998.

The changes to the deposits to the Highway Trust Fund may not be used to cause an increase in the allocations under section 157 of Title 23 of the U.S. Code or any other spending increase in direct spending other than by enactment of future legislation in compliance with the Budget Enforcement Act.

Effective Date

The provision was effective on October 1, 1997.

Revenue Effect

This provision has no net effect on Federal fiscal year budget receipts.

2. Repeal excise tax on diesel fuel used in recreational motorboats (sec. 902 of the Act and secs. 4041 and 6427 of the Code)

Present and Prior Law

Before a temporary suspension through December 31, 1997 was enacted in 1996, diesel fuel used in recreational motorboats was subject to a generally applicable 24.4-cents-per-gallon diesel fuel excise tax. Revenues from this tax were retained in the General Fund. The 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.

Reasons for Change

The Congress was informed that many marinas had found it uneconomical to carry both undyed (taxed) and dyed (untaxed) diesel

[152] Historically, the Mass Transit Account has received 20 percent of the *increase* in motor fuels tax. 20 percent of 4.3 cents is 0.86 cents. To effectuate this, a technical correction to credit 2.86 cents per gallon to the Mass Transit Account is included in Title VI (sec. 608(b)) the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

fuel because the majority of their market is for uses not subject to tax. As a result, some recreational boaters had experienced difficulty finding fuel. In 1996, the Congress suspended imposition of the tax on recreational boating while alternative collection methods were evaluated. No satisfactory alternative was found; therefore, the Congress determined that competing needs for boat fuel availability and preservation of the integrity of the diesel fuel tax compliance structure are best served by repealing the diesel fuel tax on recreational motorboat use.

Explanation of Provision

The Act repeals the application of the diesel fuel tax to fuel used in recreational motorboats.

Effective Date

The provision is effective for fuel sold after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $4 million in 1998, $5 million per year in 1999 and 2000, and $1 million per year in 2001 through 2007.

3. Continued application of tax on imported recycled halon-1211 (sec. 903 of the Act and sec. 4682 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 (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is $6.25 per pound in 1997, and is scheduled to 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. In addition, exemption is provided for imported recycled halon–1301 and halon–2402 if such chemicals are imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer. Present law further provides that exemption is to be provided for imported recycled halon–1211, for such chemicals imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer after December 31, 1997.

Reasons for Change

The Congress understood that in response to the profit incentive created by the higher price for ozone-depleting chemicals that has resulted from the tax on these chemicals, entrepreneurs have developed and are marketing a substitute for halon–1211 that is not ozone depleting. The Congress believed permitting imported recy-

cled halon–1211 to compete in the market tax free may destroy this entrepreneurial and environmental success story.

Explanation of Provision

The Act repeals the prior-law exemption for imported recycled halon–1211.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in each fiscal year from 1997 through 2007. The aggregate increase in Federal fiscal year budget receipts for the period 1997–2007 is estimated to be $1 million.

4. Uniform rate of excise tax on vaccines (sec. 904 of the Act and secs. 4131 and 4132 of the Code)

Present and Prior Law

A manufacturer's excise tax is imposed on certain vaccines routinely recommended for administration to children. Under prior law the rates of tax were as follows: DPT (diphtheria, pertussis, tetanus,), $4.56 per dose; DT (diphtheria, tetanus), $0.06 per dose; MMR (measles, mumps, or rubella), $4.44 per dose; and polio, $0.29 per dose. In general, if any vaccine was administered by combining more than one of the listed taxable vaccines, the amount of tax imposed was the sum of the amounts of tax imposed for each taxable vaccine. However, in the case of MMR and its components, any component vaccine of MMR was taxed at the same rate as the MMR-combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines.

Reasons for Change

The Congress understood that the prior-law tax rates applicable to taxable vaccines were chosen to reflect estimated probabilities of adverse reactions and the severity of the injury that might result from such reactions. The Congress understood that medical researchers believe that there is insufficient data to support fine gradations of estimates of potential harm from the various different childhood vaccines. In the light of this scientific assessment, the Congress believed some simplicity can be achieved by taxing such vaccines at the same rate per dose.

The Congress further believed it was appropriate to review the list of taxable vaccines from time to time as medical science advances. The Center for Disease Control has recommended that the vaccines for HIB (haemophilus influenza type B), Hepatitis B, and

varicella (chicken pox) be widely administered among the nation's children. In light of the growing number of immunizations using these vaccines, the Congress added these vaccines to the list of taxable vaccines.

Explanation of Provision

The Act replaces the prior-law excise tax rates, that differed by vaccine, with a single rate tax of $0.75 per dose on any listed vaccine component. Under the Act, the tax applies to any vaccine that is a combination of vaccine components is 75 cents times the number of components in the combined vaccine. For example, the MMR vaccine is taxed at a rate of $2.25 per dose and the DT vaccine is taxed at rate of $1.50 per dose.

In addition, the Act adds three new taxable vaccines to the present-law taxable vaccines: (1) HIB (haemophilus influenza type B); (2) Hepatitis B; and (3) varicella (chickenpox). The three newly listed vaccines also are subject to the 75-cents per dose excise tax.

Effective Date

The provision was effective for sales after the date of enactment (August 5, 1997). No floor stocks tax was imposed, or floor stocks refunds permitted, for vaccines held on the effective date. For the purpose of determining the amount of refund of tax on a vaccine returned to the manufacturer or importer, for vaccines returned after the date of enactment and before January 1, 1999, the amount of tax assumed to have been paid on the initial purchase of the returned vaccine is not to exceed $0.75 per dose.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $16 million in 1998, $15 million in 1999, $15 million in 2000, $15 million in 2001, $14 million in 2002, $14 million in 2003, $14 million in 2004, $14 million in 2005, $14 million in 2006, and $14 million in 2007.

5. Treat certain gasoline "chain retailers" as wholesale distributors under the gasoline excise tax refund rules (sec. 905 of the Act and sec. 6416 of the Code)

Present and Prior Law

Gasoline is taxed at 18.4 cents per gallon upon removal from a registered pipeline or barge terminal facility. Before reinstatement of a 0.1-cent-per-gallon tax rate (dedicated to the Leaking Underground Storage Tank Trust Fund) by the Act, gasoline was taxed at 18.3 cents per gallon. The position holder in the terminal at the time of removal is liable for payment of the tax. Certain uses of gasoline, including use by States and local governments, are exempt from tax. In general, these exemptions are realized by refunds to the exempt users of tax paid by the party that removed the gasoline from a terminal facility. Present law includes an exception to the general rule that refunds are made to consumers in the case of gasoline sold to States and local governments and certain other exempt users. In those cases, wholesale distributors sell

the gasoline net of tax previously paid and receive the refunds. The term wholesale distributor includes only persons that sell gasoline to producers, retailers, or to users in bulk quantities.

Reasons for Change

During recent years, States and local governments increasingly have purchased gasoline for their fleets by credit card purchases from retail outlets. Previously, these purchases were through bulk deliveries to tanks supplying private pumps at government installations. Currently, wholesale distributors are eligible to claim gasoline tax refunds on behalf of these customers. The Congress determined that allowing refunds to retail businesses of comparable size would adapt the gasoline tax rules to current market conditions without creating new opportunities for tax evasion.

Explanation of Provision

The definition of wholesale distributor is expanded to include certain "chain retailers"—retailers that make retail sales from 10 or more retail gasoline outlets. This modification conforms the definition of wholesale distributor to that which existed before 1987 when the point of collection of the gasoline tax was moved from the wholesale distribution level to removal from a terminal facility.

Effective Date

The provision was effective after the date of enactment (August 5, 1997).

Revenue Effect

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

6. Exemption of electric and other clean-fuel motor vehicles from luxury automobile classification (sec. 906 of the Act and secs. 4001 and 4003 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 $36,000. The excise tax is imposed at a rate of 8 percent for 1997 on the excess of the sales price above the designated threshold. The 8-percent rate declines by one percentage point per year until reaching 3 percent in 2002, and no tax thereafter. The $36,000 threshold is indexed for inflation. The present-law indexed threshold of $36,000 is the result of adjusting a $30,000 threshold specified in the Code for inflation occurring after 1990 (sec. 4001(e)).

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. A tax, at the same rate, is imposed on the separate purchase of parts and accessories for a vehicle within six months of the first retail sale when the sum of the separate purchases of the vehicle, parts, and accessories exceeds the luxury tax threshold (sec. 4003).

The tax applies to sales before January 1, 2003.

Reasons for Change

The Congress believed that the price of a clean-burning fuel vehicle or an electric vehicle does not necessarily represent the consumer's purchase of a luxury good in the sense intended with the enactment of the luxury excise tax on automobiles in the Omnibus Budget Reconciliation Act of 1990. Rather, the higher price of such vehicles often represents the cost of the technology required to produce an automobile designed to provide certain environmental benefits. The Congress believed the cost of this technology should not be considered a luxury for the purpose of the luxury excise tax on automobiles. Therefore, the Congress determined it appropriate to modify the threshold above which the luxury automobile excise tax applies in the case of certain clean-burning fuel vehicles and electric vehicles.

Explanation of Provision

The Act modifies the threshold above which the luxury excise tax on automobiles will apply for each of two identified classes of automobiles both in the case of a purchase of a vehicle and in the case of the separate purchase of a vehicle and parts and accessories therefor. First, for an automobile that is not a clean-burning fuel vehicle to which retrofit parts and components are installed to make the vehicle a clean-burning vehicle, the threshold would be $30,000, as adjusted for inflation under present law, plus an amount equal to the increment to the retail value of the automobile attributable to the retrofit parts and components installed.

In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the threshold applicable for any year is modified to equal 150 percent of $30,000, with the result increased for inflation occurring after 1990 and rounded to next lowest multiple of $2,000.

Effective Date

The provision was effective for sales and installations occurring after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 for the 1997 fiscal year, by $1 million for the 1998 fiscal year, by $1 million for the 1999 fiscal year, by less than $500,000 for each fiscal year from 2000 through 2003, and to have no effect on Federal receipts thereafter (provision expires December 31, 2002). The aggregate reduction in Federal fiscal year budget receipts for fiscal year 1997 through fiscal year 2007 is estimated to be $2 million.

7. Tax certain alternative fuels based on energy equivalency to gasoline (sec. 907 of the Act and secs. 4041 and 9503 of the Code)

Present and Prior Law

Excise taxes are imposed on gasoline, diesel fuel, and special motor fuels used in highway vehicles. Before enactment of the Act, 4.3 cents per gallon of each of these taxes was retained in the General Fund, with the balance of the revenues being dedicated to one or more Trust Funds.[153] The tax on gasoline is 18.4 cents per gallon; the tax on diesel fuel is 24.4 cents per gallon; and the tax on special motor fuels generally is 18.4 cents per gallon. Taxable special motor fuels include liquefied petroleum gas ("propane"), liquefied natural gas ("LNG"), and methanol from natural gas. Compressed natural gas ("CNG") also is taxed when used as a fuel in highway vehicles. Special rates apply to methanol from natural gas (exempt from 7 cents of the prior-law 14-cents-per-gallon Highway Trust Fund component of the special motor fuels tax), and compressed natural gas (exempt from the entire prior-law Highway Trust Fund component of the tax).

In general, these four special fuels contain less energy (i.e., fewer Btu's) per gallon than does gasoline.

Reasons for Change

Under prior law, the largest portion of the excise tax on propane, LNG, and methanol from natural gas was imposed to finance Federal highway programs through the Highway Trust Fund. Under the Act, these revenues are dedicated exclusively to the Highway Trust Fund. A basic principle of the highway taxes is that users of the highway system should be taxed in relation to their use of the system. The Congress believed that adjusting the tax rates on these three special fuels is consistent with that principle because consumers must purchase more gallons of these lower-energy-content fuels than gallons of gasoline to travel the same number of miles.

Explanation of Provision

The Act adjusts the tax rates on propane, LNG, and methanol from natural gas to reflect the respective energy equivalence of the fuels to gasoline. The revised Highway Trust Fund tax rates on these fuels are: propane, 13.6 cents per gallon; LNG 11.9 cents per gallon, and methanol from natural gas, 9.15 cents per gallon.

The Act provides that revenues from the Highway Trust Fund portion of these taxes and the tax on CNG will be divided between the Highway and Mass Transit Accounts of that Trust Fund in the same proportion as applies to the Highway Trust Fund tax on gasoline.[154]

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[153] Section 901 of the Act provides that revenues from all but 0.1-cent-per gallon of the taxes on highway fuels is to be deposited in the Highway Trust Fund; the remaining 0.1-cent-per gallon (which was reinstated by sec. 1033 of the Act) is dedicated to the Leaking Underground Storage Tank Trust Fund.

[154] A technical correction may be necessary to implement this provision. Such a correction is included in Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House November 5, 1997.

Effective Date

The provision was effective for fuels sold or used after September 30, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1997, $15 million in 1998, $16 million per year in 1999 and 2000, $17 million in 2001, $18 million in 2002, $19 million in 2003, $20 million in 2004, $21 million in 2005, $22 million in 2006, and $23 million in 2007.

8. Reduced rate of alcohol excise tax on certain hard ciders (sec. 908 of the Act and sec. 5041 of the Code)

Present and Prior Law

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of $1.07 per wine gallon. The Code defines still wines as wines containing not more than 0.392 gram of carbon dioxide per hundred milliliters of wine. Higher rates of tax are applied to wines with greater alcohol content, to sparkling wines (e.g., champagne), and to artificially carbonated wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually (i.e., net tax rate of 17 cents per wine gallon). Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer produced annually.

Apple cider containing alcohol ("hard cider") is classified as wine, and was taxed as wine under prior law.

Reasons for Change

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

Explanation of Provision

The Act adjusts the tax rate on "hard cider" that was taxed as a still wine under prior law (i.e., a cider containing not more than 0.392 gram of carbon dioxide per hundred milliliters),[155] to 22.6 cents per gallon for those persons who produce more than 100,000

[155] A technical correction may be required to clarify that the reduced rate of tax provided by this provision applies only to apple cider taxable as a still wine under prior law.

gallons of "hard cider" during a calendar year. The provision defines "hard cider" as being fermented solely from apples or apple concentrate and water, containing no other fruit product and containing at least one-half of 1 percent and less than 7 percent alcohol by volume. Once fermented, eligible hard cider may not be altered by the addition of other fruit juices, flavor, or other ingredient that alters the flavor that results from the fermentation process. Thus, for example, cider fermented from apples, but which has raspberry flavor added to it prior to bottling and marketing to the public, will not be eligible for the 22.6 cents-per-gallon tax rate.

Qualifying small producers that produce 250,000 gallons or less of hard cider and other wines in a calendar year may claim a credit of 5.6 cents per wine gallon on the first 100,000 gallons of hard cider produced. This credit produces an effective tax rate of 17 cents per gallon, the same effective rate as under prior law that applied to small producers who were permitted to claim the 90 cents-per-gallon credit for small wineries. Hard cider production will continue to be counted in determining whether other production of a producer qualifies for the tax credit for small producers of wine. The Act does not change the classification of qualifying hard cider as wine.

Effective Date

The provision was effective for hard cider removed after September 30, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by approximately $1 million in each fiscal year from 1998 through fiscal year 2007, and an estimated total reduction in Federal receipts of $7 million for the period 1998–2007.

9. Study feasibility of moving collection point for distilled spirits excise tax (sec. 909 of the Act)

Present and Prior Law

Distilled spirits are subject to tax at $13.50 per proof gallon. (A proof gallon is a liquid gallon consisting of 50 percent alcohol.) In the case of domestically produced distilled spirits and distilled spirits imported in to the United States in bulk containers for domestic bottling, the tax is collected on removal of the beverage from the distillery (without regard to whether a sale occurs at that time). Bottled distilled spirits that are imported into the United States comprise approximately 15 percent of the current market for these beverages; tax is collected on these imports when the distilled spirits are removed from the first customs bonded warehouse in which they are deposited upon entry into the United States.

In the case of certain distilled spirits products, a tax credit for alcohol derived from fruit is allowed. This credit reduces the effective tax paid on those beverages. The credit is determined when the tax is paid (i.e., at the distillery or on importation).

Explanation of Provision

The Act directs the Treasury Department to study options for changing the point at which the distilled spirits excise tax is collected. One of the options evaluated should be collecting the tax at the point at which the distilled spirits are removed from registered wholesale warehouses. As part of this study, the Treasury is to focus on administrative issues associated with identified options, including the effects on tax compliance. For example, the Treasury is to evaluate the actual compliance record of wholesale dealers that currently pay the excise tax on imported bottled distilled spirits and the compliance effects of allowing additional wholesale dealers to be distilled spirts taxpayers. The study also is to address the number of taxpayers involved, the types of financial responsibility requirements that might be needed, and any special requirements regarding segregation of non-tax-paid distilled spirits from other products carried by the potential new taxpayers. The study further is to review the effects of the options on Treasury staffing and other budgetary resources as well as projections of the time between when tax currently is collected and the time when tax otherwise would be collected.

The study is required to be completed and transmitted to the Senate Committee on Finance and the House Committee on Ways and Means no later than March 31, 1998.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

10. Codify Treasury Department regulations regulating wine labels (sec. 910 of the Act and sec. 5388 of the Code)

Present and Prior Law

The Code includes provisions regulating the labeling of wine when it is removed from a winery for marketing. In general, the regulations under these provisions allow the use of semi-generic names for wine that reflect geographic identifications understood in the industry, provided that the labels include clear indication of any deviation from that which is generally understood as to the source of the grapes or the process by which the wine is produced.

Reasons for Change

The Congress determined that the Treasury Department regulations governing the use of semi-generic designations such as "Chablis" and "burgundy" in wine labeling should be codified to add clarity to the existing Code provisions.

Explanation of Provision

The Act codifies the Treasury Department regulations governing the use of semi-generic wine designations which reflect geographic origin into the Code's wine labeling provisions.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

B. Disaster Relief Provisions

1. Authority to postpone certain tax-related deadlines by reason of presidentially declared disaster (sec. 911 of the Act and sec. 7508A of the Code)

Present and Prior Law

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some (but not all) tax-related deadlines.

Reasons for Change

The Congress believed that the Secretary should have the authority to postpone additional tax-related deadlines.

Explanation of Provision

The Secretary of the Treasury may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a Presidentially declared disaster. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The provision does not apply for purposes of determining interest on any overpayment or underpayment. However, section 915 of the Act provides for the abatement of interest in the case of individuals living in an area that has been declared a disaster area by the President during 1997.

Effective Date

The provision was effective for any period for performing an act that had not expired before the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by a negligible amount.

2. Use of certain appraisals to establish amount of disaster loss (sec. 912 of the Act and sec. 165 of the Code)

Present and Prior Law

In order to claim a disaster loss, a taxpayer must establish the amount of the loss. This may, for example, be done through the use of an appraisal.

Reasons for Change

The Congress believed that no impediment should exist to utilizing alternate types of acceptable appraisals as proof to establish the amount of loss.

Explanation of Provision

Nothing in the Code will be construed to prohibit Treasury from issuing guidance providing that an appraisal for the purpose of obtaining a Federal loan or Federal loan guarantee as the result of a Presidentially declared disaster may be used to establish the amount of a disaster loss.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by a negligible amount.

3. Treatment of livestock sold on account of weather-related conditions (sec. 913 of the bill and secs. 451 and 1033 of the Code)

Present and Prior Law

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Con-

sequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Reasons for Change

The Congress believed that the present-law exceptions to gain recognition for livestock sold on account of drought should apply to livestock sold on account of floods and other weather-related conditions as well.

Explanation of Provision

The Act amends Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the Act amends Code section 1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The provision applies to sales and exchanges after December 31, 1996.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $12 million in 1998, $2 million in 1999, $2 million in 2000, $2 million in 2001, $1 million in 2002, $1 million in 2003, $1 million in 2004, $1 million in 2005, $1 million in 2006, and $1 million in 2007.

4. Mortgage bond financing for residences located in Presidentially declared disaster areas (sec. 914 of the Act and sec. 143 of the Code)

Present and Prior Law

Qualified mortgage bonds are private activity tax-exempt bonds issued by States and local governments acting as conduits to provide mortgage loans to first-time home buyers who satisfy specified income limits and who purchase homes that cost less than statutory maximums.

Present and prior law waives these three buyer targeting requirements for a portion of the loans made with proceeds of a

qualified mortgage bond issue if the loans are made to finance homes in statutorily prescribed economically distressed areas.

Reasons for Change

The Congress believed that qualified mortgage bond financing is an appropriate tool to assist persons experiencing losses in Presidentially declared disasters to repair or replace their homes.

Explanation of Provision

The Act waives the first-time homebuyer requirement, and treats the affected areas as economically distressed areas for purposes of applying the income limits, and the purchase price limits in the case of loans to finance homes damaged as a result of certain Presidentially declared disasters.[156] The waiver applies only during the two-year period following the date of the disaster declaration.

Effective Date

The provision applies to loans financed with bonds issued after December 31, 1996, and before January 1, 1999.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million in 1998, $7 million in 1999, $8 million in 2000, $8 million in 2001, $7 million in 2002, $6 million in 2003, $6 million in 2004, $5 million in 2005, $4 million in 2006, and $4 million in 2007.

5. Requirement to abate interest by reason of Presidentially declared disaster (sec. 915 of the Act)

Present and Prior Law

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some tax-related deadlines, but there is no authority to abate interest.

Reasons for Change

The Congress believed that the abatement of interest should accompany the Secretary's authority to postpone the filing and payment deadlines, in the case of certain Presidentially declared disasters.

Explanation of Provision

If the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997, no interest shall be charged as a result of the failure of an individual taxpayer to file an individual tax return, or pay the taxes shown on such return, during the extension. For this purpose, an individual tax return does not include the return of a trust or estate.

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[156] A technical correction may be necessary to clarify the circumstances in which homebuyers qualify for these exceptions from the qualified mortgage bond financing rules.

Effective Date

The provision is effective with respect to declarations during 1997 that an area warrants assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 1997.

C. Provisions Relating to Employment Taxes

1. Clarification of standard to be used in determining tax status of retail securities brokers (sec. 921 of the Act)

Present and Prior Law

Under present and prior law, whether a worker is an employee or independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship is generally found to exist if the service recipient has not only the right to control the result to be accomplished by the work, but also the means by which the result is to be accomplished. The Internal Revenue Service ("IRS") generally takes the position that the presence and extent of instructions is important in reaching a conclusion as to whether a business retains the right to direct and control the methods by which a worker performs a job, but that it is also important to consider the weight to be given those instructions if they are imposed by the business only in compliance with governmental or governing body regulations. The IRS training manual provides that if a business requires its workers to comply with rules established by a third party (e.g., municipal building codes related to construction), the fact that such rules are imposed should be given little weight in determining the worker's status.

Reasons for Change

Broker-dealers are required to supervise the activities of their affiliated registered representatives in order to comply with certain investor protection laws. The Congress believed that such supervision should not be taken into account in determining the status of a broker for Federal tax purposes.

Explanation of Provision

Under the Act, in determining the status of a registered representative of a broker-dealer for Federal tax purposes, no weight may be given to instructions from the service recipient which are imposed only in compliance with governmental investor protection standards or investor protection standards imposed by a governing body pursuant to a delegation by a Federal or State agency.

Effective Date

The provision is effective with respect to services performed after December 31, 1997. No inference is intended that the treatment under the proposal is not present law.

Revenue Effect

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

2. Clarification of exemption from self-employment tax for certain termination payments received by former insurance salesmen (sec. 922 of the Act and sec. 1402 of the Code)

Present Law and Prior Law

Under present and prior law, as part of the Federal Insurance Contributions Act ("FICA") a tax is imposed on employees and employers. The tax consists of two parts: old-age, survivor, and disability insurance ("OASDI") and Medicare Hospital Insurance ("HI"). For wages paid in 1997, the OASDI tax rate is 6.2 percent of wages up to $65,400 (indexed for inflation) on both the employer and employee. The HI tax rate on both the employer and the employee is 1.45 percent of wages (with no wage cap).

Similarly, under the self-employment contributions act ("SECA"), taxes are imposed on an individual's net earnings from self employment. In general, net earnings from self employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business. The SECA tax rate is the same as the combined employer and employee FICA rates (i.e., 12.4 percent for OASDI and 2.9 percent for HI) and the maximum amount of earnings subject to the OASDI portion of SECA taxes is coordinated with and is set at the same level as the maximum level of wages and salaries subject to the OASDI portion of FICA taxes. There is no limit on the amount of self-employment income subject to the HI portion of the tax.

Certain insurance salesmen are independent contractors and therefore subject to tax under SECA.

Under case law, certain payments received by former insurance salesmen who had sold insurance as independent contractors are not net earnings from self employment and therefore are not subject to SECA. See, e.g., *Jackson* v. *Comm'r,* 108 TC ____ No. 10 (1997); *Gump* v. *U.S.,* 86 F. 3d 1126 (CA FC 1996); *Milligan* v. *Comm'r,* 38 F. 3d 1094 (9th Cir. 1994).

Reasons for Change

The Congress believed that clarifying the SECA tax treatment of certain payments would provide greater certainty to taxpayers and would reduce the need for further litigation.

Explanation of Provision

The Act codifies case law by providing that net earnings from self employment do not include any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if (1) such amount is received after termination of the individual's agreement to perform services for the company, (2) the individual performs no services for the company after such termination and before the close of the taxable year, (3) the amount of the payment depends primarily on policies sold by or credited to the account of the individual during the last year of the service agreement and/or the extent to which such policies remain in force for some period after such termination, and does not depend on the length of service or overall earnings from services performed for the company, and (4) the payments are conditioned upon the salesman agreeing not to compete with the company for at least one year following such termination. Eligibility for the payments can be based on length of service or overall earnings.

The Act also amends the Social Security Act to provide that such termination payments are not treated as earnings for purposes of determining social security benefits.

No inference is intended with respect to the SECA tax treatment of payments that are not described in the proposal.

Effective Date

The provision is effective with respect to payments after December 31, 1997. No inference is intended that the proposal is not present law.

Revenue Effect

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

D. Provisions Relating to Small Businesses

1. Delay imposition of penalties for failure to make payments electronically through EFTPS (sec. 931 of the Act and sec. 6302 of the Code)

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)[157]). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[158] Employers

[157] This requirement was enacted in 1993 (sec. 523 of P.L. 103–182).

[158] Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

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.

Treasury originally 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. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) will not take effect until July 1, 1997.[159] This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

On June 2, 1997, the IRS announced[160] that it will not impose penalties through December 31, 1997, on businesses that make timely deposits using paper federal tax deposit coupons while converting to the EFTPS system.

Reasons for Change

The Congress believed that it is necessary to provide small businesses with additional time prior to implementation of the requirements so that these employers may be better informed about their responsibilities.

Explanation of Provision

The Act provides that no penalty shall be imposed solely by reason of a failure to use EFTPS prior to July 1, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

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[159] Section 1809 of P.L. 104–188.
[160] IR–97–32.

2. Home office deduction: clarification of definition of principal place of business (sec. 932 of the 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)).[161] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home (sec. 280A(f)(1)). Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94–47, 1994–29 I.R.B. 6).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress adopted section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In *Commissioner* v. *Soliman,* 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals.[162] Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not

[161] If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., *W. Michael Mathes,* T.C. Memo 1990–483.

[162] In response to the Supreme Court's decision in *Soliman,* the IRS revised its *Publication 587, Business Use of Your Home,* to more closely follow the comparative analysis used in *Soliman* by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location.

available under the second or third exception under section 280A(c)(1) (described above).

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 or product samples 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 the Supreme Court's decision in Soliman unfairly denied a home office deduction to a growing number of taxpayers who manage their business activities from their homes. Thus, the statutory modification adopted by the Congress will reduce the prior-law bias in favor of taxpayers who manage their business activities from outside their homes, thereby enabling more taxpayers to work efficiently at home, save commuting time and expenses, and spend additional time with their families. Moreover, the statutory modification is an appropriate response to the computer and information revolution, which has made it more practical for taxpayers to manage trade or business activities from a home office.

Explanation of Provision

Section 280A is amended to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business. As under present law, deductions will be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer.

Thus, under the provision, a home office deduction is allowed (subject to the present-law "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction under the provision. Moreover, if a taxpayer conducts some administrative or management

activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the provision will not be affected by the fact that the taxpayer conducts substantial *non-administrative* or *non-management* business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second part of the test will be satisfied, regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law "convenience of the employer" test is satisfied. In cases where a taxpayer's use of a home office does not satisfy the provision's two-part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of section 280A.

Effective Date

The provision applies to taxable years beginning after December 31, 1998.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $119 million in 1999, $244 million in 2000, $253 million in 2001, $263 million in 2002, $274 million in 2003, $285 million in 2004, $295 million in 2005, $306 million in 2006, and $318 million in 2007.

3. Income averaging for farmers (sec. 933 of the Act and sec. 1301 of the Code)

Prior Law

The ability of an individual taxpayer to reduce his or her tax liability by averaging his or her income over a number of years was repealed by the Tax Reform Act of 1986.

Explanation of Provision

In general, an individual taxpayer is allowed to elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or a portion of his or her taxable income from the trade or business of farming.

The provision operates such that an electing eligible taxpayer (1) designates all or a portion of his or her taxable income attributable

to any farming business[163] of the taxpayer from the current year as "elected farm income;"[164] (2) allocates one-third of such "elected farm income" to each of the prior three taxable years; and (3) determines his or her current year section 1 tax liability by determining the sum of (a) his or her current year section 1 liability without the elected farm income allocated to the three prior taxable years plus (b) the increases in the section 1 tax for each of the three prior taxable years by taking into account the allocable share of the elected farm income for such years. If a taxpayer elects the operation of the provision for a taxable year, the allocation of elected farm income among taxable years pursuant to the election shall apply for purposes of any election in a subsequent taxable year.

Taxable income attributable to any farming business may include gain from the sale or other disposition of property (other than land) regularly used by the taxpayer in his or her farming business for a substantial period.

The provision does not apply for employment tax purposes, or to an estate or a trust. Further, the provision does not apply for purposes of the alternative minimum tax under section 55. Finally, the provision does not require the recalculation of the tax liability of any other taxpayer, including a minor child required to use the tax rates of his or her parents under section 1(g).

The election shall be made in the manner prescribed by the Secretary of the Treasury and, except as provided by the Secretary, shall be irrevocable. In addition, the Secretary of the Treasury shall prescribe such regulations as are necessary to carry out the purposes of the provision, including regulations regarding the order and manner in which items of income, gain, deduction, loss, and credits (and any limitations thereon) are to be taken into account for purposes of the provision and the application of the provision to any short taxable year. It is expected that such regulations will deny the multiple application of items that carry over from one taxable year to the next (e.g., net operating loss or tax credit carryovers).

Effective Date

The provision is effective for taxable years beginning after December 31, 1997, and before January 1, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1997, $10 million in 1998, $53 million in 1999, $54 million in 2000, and $50 million in 2001.

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[163] The term "farming business" has the same meaning given such term by sec. 263A(e)(4).

[164] The amount of elected farm income of a taxpayer for a taxable year may not exceed the taxable income attributable to any farming business for the year.

4. Increase deduction for health insurance costs of self-employed individuals (sec. 934 of the Act and sec. 162(l) of the Code)

Present and Prior Law

Under present and prior law, self-employed individuals are entitled to deduct a portion of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents. Under prior law, the deduction was 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. 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.

Under present and prior law employees can exclude from income 100 percent of employer-provided health insurance.

Reasons for Change

The Congress believed that it was appropriate to continue to increase the amount self-employed individuals are entitled to deduct for their health insurance expenses.

Explanation of Provision

The Act permits self-employed individuals to deduct a higher percentage of the amount paid for health insurance is as follows: the deduction is 40 percent in 1997, 45 percent in 1998 and 1999, 50 percent in 2000 and 2001, 60 percent in 2002, 80 percent in 2003 through 2005, 90 percent in 2006, and 100 percent in 2007 and all years thereafter.

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 $39 million in 2000, $120 million in 2001, $224 million in 2002, $605 million in 2003, $882 million in 2004, $601 million in 2005, $404 million in 2006, and $604 million in 2007.

5. Moratorium on regulations regarding employment taxes of limited partners (sec. 935 of the Act and sec. 1402 of the Code)

Present and Prior Law

Under the Self-Employment Contributions Act, taxes are imposed on an individual's net earnings from self employment. A limited partner's net earnings from self employment include guaranteed payments made to the individual for services actually rendered and do not include a limited partner's distributive share of

the income or loss of the partnership. The Department of the Treasury issued proposed regulations defining a limited partner for this purpose. These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. The regulations were proposed to be effective with the individual's first taxable year beginning on or after the date the regulations are published in the Federal Register.

Explanation of Provision

Any regulations relating to the definition of a limited partner for self-employment tax purposes cannot be issued or effective before July 1, 1998.

Revenue Effect

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

E. Expensing of Environmental Remediation Costs ("Brownfields") (sec. 941 of the Act and new sec. 198 of the Code)

Present and Prior Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary

current business expense. *Woolrich Woolen Mills* v. *United States*, 289 F.2d 444 (3d Cir. 1961) .

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In *Plainfield-Union Water Co.* v. *Commissioner*, 39 T.C. 333 (1962), nonacq., 1964–2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the *Plainfield-Union* valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94–38, 1994–1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the *Plainfield-Union* valuation analysis.[165] However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it pur-

[165] Rev. Rul. 94–38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

chased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (TAM 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

Reasons for Change

To encourage the cleanup of contaminated sites, as well as to eliminate uncertainty regarding the appropriate treatment of environmental remediation expenditures for Federal tax law purposes, the Congress believed that it is appropriate to provide clear and consistent rules regarding the Federal tax treatment of certain environmental remediation expenses.

Explanation of Provision

The Act provides that taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner* v. *Idaho Power Co.*[166] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law and under the Act[167] (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above.

Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980

[166] *Commissioner* v. *Idaho Power Co.,* 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

[167] Thus, the 22 additional empowerment zones authorized to be designated under the Act, as well as the D.C. Enterprise Zone established under Title VII of the Act, are "targeted areas" for purposes of this provision.

("CERCLA") cannot qualify as targeted areas. The chief executive officer of a State, in consultation with the Administrator of the EPA, could designate an appropriate State environmental agency. If no State environmental agency was so designated within 60 days of the date of enactment, the appropriate environmental agency for such State shall be designated by the Administrator of the EPA. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The Act further provides that, in the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the Act is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon sale or other disposition of the property. The Act also provides that sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) shall not apply to amounts which are treated as expenses under this provision.

Finally, the Congress clarified that providing current deductions for certain environmental remediation expenditures under the Act creates no inference as to the proper treatment of other remediation expenditures not described in the Act.

Effective Date

The provision applies only to eligible expenditures paid or incurred in taxable years ending after August 5, 1997 (the date of enactment), and before January 1, 2001.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $57 million in 1998, $132 million in 1999, $165 million in 2000, and $63 million in 2001. The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in 2002, $2 million in 2003, $9 million in 2004, $17 million in 2005, $19 million in 2006, and $18 million in 2007.

F. Empowerment Zones and Enterprise Communities (secs. 951–956 of the Act and secs. 1391, 1392, 1394, 1396, 1397A, 1397B, and 1397C of the Code)

Present and Prior Law

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six

empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[168] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392).

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone;[169] (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,000 of expensing for section 179 property placed in service in 1997); and (3) special tax-exempt financing for certain zone facilities (described in more detail below).

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally are available during the period that the designation remains in effect—i.e., the 10-year period of 1995 through 2004.

Definition of "qualified zone property"

Section 1397C defines "qualified zone property" as depreciable tangible property provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000 (whichever is greater).

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[168] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

[169] For wages paid in calendar years during the period 1994 through 2001, the credit rate is 20 percent. The credit rate will be reduced to 15 percent for calendar year 2002, 10 percent for calendar year 2003, and 5 percent for calendar year 2004. No wage credit will be available after 2004.

Definition of "enterprise zone business"

Prior to enactment of the Taxpayer Relief Act of 1997 (the Act), section 1397B defined the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) every trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community;[170] (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the business's tangible property is used within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than 5 percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[171] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. Prior to enactment of the Act, the rental of tangible personal property to others was not a qualified business unless substantially all of the rental of such property was by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State.

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above),[172] the principal user of which is an "enterprise zone business" (also defined above), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community. These bonds may only be issued while an

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[170] A qualified proprietorship is *not* required to meet a requirement that every trade or business of the proprietor is the active conduct of a qualified business within the empowerment zone or enterprise community.

[171] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B)(i.e., a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises) or certain large farms.

[172] For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all qualified enterprise zone bonds for each qualified enterprise zone business may not exceed $3 million per zone or community. In addition, total qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all zones and communities.

Reasons for Change

The Congress believed that it is appropriate to provide for the designation of additional empowerment zones and to liberalize the definition of "enterprise zone business" and tax-exempt financing rules that apply for purposes of all empowerment zones and enterprise communities. In addition, in view of the unique characteristics of the States of Alaska and Hawaii, and the economically depressed areas within those States, the Congress believed that the generally applicable criteria for designation of empowerment zones and enterprise communities should be modified in the event of future designations of such zones or communities in those States.

Explanation of Provision

Two additional empowerment zones with same tax incentives as previously designated empowerment zones

The Act authorizes the Secretary of HUD to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas) with respect to which apply the same tax incentives (i.e., the wage credit, additional expensing, and special tax-exempt financing) as are available within the empowerment zones authorized by OBRA 1993.[173] The two additional empowerment zones are subject to the same eligibility criteria under present-law section 1392 that applied to the original six urban empowerment zones. In order to permit designation of these two additional empowerment zones, the aggregate population cap applicable to empowerment zones located in urban areas is increased from 750,000 to a cap of one million aggregate population for the eight urban empowerment zones.

The two additional empowerment zones must be designated within 180 days after enactment (i.e., the designations must be made by February 1, 1998). However, a special rule provides that the designations of these two additional empowerment zones will not take effect until January 1, 2000 (and generally will remain in effect for 10 years).

Designation of additional 20 empowerment zones

The Act also authorizes the Secretaries of HUD and Agriculture to designate an additional 20 empowerment zones (no more than

[173] The wage credit available in the two new urban empowerment zones is modified slightly to provide that the credit rate will be 20 percent for calendar years 2000–2004, 15 percent for calendar year 2005, 10 percent for calendar year 2006, and 5 percent for calendar year 2007. No wage credit will be available in the two new urban empowerment zones after 2007.

15 in urban areas and no more than five in rural areas).[174] With respect to these additional empowerment zones, the present-law eligibility criteria are expanded slightly in comparison to the eligibility criteria provided for by OBRA 1993. First, the general square mileage limitations (i.e., 20 square miles for urban areas and 1,000 square miles for rural areas) are expanded to allow the empowerment zones to include an additional 2,000 acres. This additional acreage, which could be developed for commercial or industrial purposes, is not subject to the poverty rate criteria and may be divided among up to three noncontiguous parcels. In addition, the general requirement that at least half of the nominated area consist of census tracts with poverty rates of 35 percent or more does not apply to the 20 additional empowerment zones. However, under present-law section 1392(a)(4), at least 90 percent of the census tracts within a nominated area must have a poverty rate of 25 percent or more, and the remaining census tracts must have a poverty rate of 20 percent or more.[175] For this purpose, census tracts with populations under 2,000 are treated as satisfying the 25-percent poverty rate criteria if (1) at least 75 percent of the tract was zoned for commercial or industrial use, and (2) the tract is contiguous to one or more other tracts that actually have a poverty rate of 25 percent or more.[176]

Within the 20 additional empowerment zones, qualified "enterprise zone businesses" are eligible to receive up to $20,000 of additional section 179 expensing[177] and to utilize special tax-exempt financing benefits. In addition the so-called "brownfields" tax incentive (provided for by the Act, see E., above) is available. This incentive allows taxpayers to expense (rather than capitalize) certain environmental remediation expenditures incurred before January 1, 2001, at contaminated sites located within new or previously designated empowerment zones or enterprise communities, as well as certain other targeted areas. However, businesses within the 20 additional empowerment zones are *not* eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit is available only within in the nine zones designated under OBRA 1993 and the two urban zones designated under the Act that are eligible for the same tax incentives as are available in the nine zones designated under OBRA 1993).

The 20 additional empowerment zones are required to be designated before 1999, and the designations generally will remain in effect for 10 years.

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[174] In contrast to OBRA 1993, areas located within Indian reservations are eligible for designation as one or more of the additional 20 empowerment zones under the Act.

[175] In lieu of the poverty criteria, out migration may be taken into account in designating one rural empowerment zone.

[176] A special rule enacted as part of the Act modifies the present-law empowerment zone and enterprise community designation criteria so that any zones or communities designated in the future in the States of Alaska or Hawaii will not be subject to the general size limitations, nor will such zones or communities be subject to the general poverty-rate criteria. Instead, nominated areas in either State will be eligible for designation as an empowerment zone or enterprise community if, for each census tract or block group within such area, at least 20 percent of the families have incomes which are 50 percent or less of the State-wide median family income. Such zones and communities will be subject to the population limitations under present-law section 1392(a)(1).

[177] However, the additional section 179 expensing is *not* available for any property substantially all the use of which is within the additional 2,000 acres allowed to be included under the Act within an empowerment zone.

Modification of definition of enterprise zone business

The Act modifies the prior-law requirement of section 1397B that an entity may qualify as an "enterprise zone business" only if (in addition to the other criteria) at least 80 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community. The Act liberalizes this requirement by reducing the percentage threshold so that an entity may qualify as an enterprise zone business if at least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community (assuming that the other criteria of section 1397B are satisfied). In addition, section 1397B is modified so that rather than requiring that "substantially all" tangible and intangible property (and employee services) of an enterprise zone business be used (and performed) within a designated empowerment zone or enterprise community, a "substantial portion" of tangible and intangible property (and employee services) of an enterprise zone business must be used (and performed) within a designated zone or community. Moreover, the Act further amends the section 1397B rule governing intangible assets so that a substantial portion of an entity's intangible property must be used in the active conduct of a qualified business within an empowerment zone or enterprise community, but there is no need (as under prior law) to determine whether the use of such assets is "exclusively related to" such business.

Thus, as a result of the modifications made by the Act, section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) every trade or business [178] of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 50 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) a substantial portion of the business's tangible property is used within a zone or community; (4) a substantial portion of the business's intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) less than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

As under prior law, section 1397B(d)(4) continues to provide that a "qualified business" does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license. The Act also clarifies that an enterprise zone business that leases to others commercial real property within a zone or community may rely on a lessee's certification that the les-

[178] A technical correction may be necessary to clarify that, for purposes of this provision, as well as for purposes of defining the term "qualified business," the term "trade or business" encompasses activities carried on a not-for-profit, as well as a for-profit basis. For example, a trade association could be an "enterprise zone business" if all the requirements of section 1397B were satisfied.

see is an enterprise zone business. Finally, the Act provides that the rental to others of tangible personal property shall be treated as a qualified business if and only if at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a zone or community (rather than the prior-law requirement that "substantially all" tangible personal property rentals of an enterprise zone business satisfy this test).

This modified "enterprise zone business" definition is effective for taxable years beginning on or after August 5, 1997, with respect to all previously designated empowerment zones and enterprise communities, the two urban empowerment zones to be designated under the Act with the same tax incentives as the previously designated empowerment zones, and the 20 additional empowerment zones to be designated under the Act.[179]

Tax-exempt financing rules

Exceptions to volume cap and issue size

So-called "new empowerment zone facility bonds" are allowed to be issued for qualified enterprise zone businesses in the 20 additional empowerment zones authorized to be designated under the Act. These "new empowerment zone facility bonds" are not subject to the State private activity bond volume caps or the special limits on issue size generally applicable to qualified enterprise zone facility bonds under section 1394(c).[180] The maximum amount of these bonds that may be issued is limited to $60 million per rural zone, $130 million per urban zone with a population of less than 100,000, and $230 million per urban zone with a population of 100,000 or more.

Changes to certain rules applicable to both empowerment zone facility bonds and qualified enterprise community facility bonds

Qualified enterprise zone businesses located in newly designated empowerment zones and enterprise communities—as well as qualified enterprise zone businesses located in previously designated empowerment zones and enterprise communities—are eligible for special tax-exempt bond financing under prior-law rules, subject to the modifications described below (and the exceptions to the volume cap and issue size described above for the 20 additional empowerment zones authorized to be designated under the Act).

The Act waives until the end of a "startup period" the requirement that 95 percent or more of the proceeds of bond issue be used by a qualified enterprise zone business. With respect to each property, the startup period ends at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years

[179] In addition, the modifications to the enterprise zone business definition generally apply (with certain exceptions) for purposes of defining a "D.C. Zone business" under certain provisions of the Act that provide tax incentives for the District of Columbia (as described in Title VII, above).

[180] "New empowerment zone facility bonds" may not be issued with respect to the two urban empowerment zones to be designated under the Act with the same tax incentives as the previously designated empowerment zones.

after the date of bond issuance). This waiver is available only if, at the beginning of the startup period, there is a reasonable expectation that the use by a qualified enterprise zone business would be satisfied at the end of the startup period and the business makes bona fide efforts to satisfy the enterprise zone business definition.

The Act also waives the requirements of an enterprise zone business (other than the requirement that at least 35 percent of the business' employees be residents of the zone or community) for all years after a prescribed testing period equal to first three taxable years after the startup period.

Finally, the Act relaxes the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds. In the case of property which is substantially renovated by the taxpayer, the property need not be acquired by the taxpayer after empowerment zone or enterprise community designation or originally used by the taxpayer within the zone if, during any 24-month period after empowerment zone or enterprise community designation, the additions to the taxpayer's basis in the property exceed 15 percent of the taxpayer's basis at the beginning of the period, or $5,000 (whichever is greater).

Effective Date

The two additional urban empowerment zones (within which would be available the same tax incentives as are available in the empowerment zones designated pursuant to OBRA 1993) must be designated by February 1, 1998, but the designation will not take effect until January 1, 2000. The 20 additional empowerment zones (within which the wage credit will not be available) are to be designated after enactment of the Act but prior to January 1, 1999. For purposes of the additional section 179 expensing available within empowerment zones, the modifications to the definition of "enterprise zone business" are effective for taxable years beginning on or after the date of enactment of the Act (i.e., August 5, 1997).

The modifications to the tax-exempt financing rules are effective for qualified enterprise zone facility bonds and the new empowerment zone facility bonds issued after August 5, 1997.

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $82 million in 1998, $121 million in 1999, $159 million in 2000, $185 million in 2001, $171 million in 2002, $154 million in 2003, $122 million in 2004, $94 million in 2005, $64 million in 2006, and $38 million in 2007.

G. Other Provisions

1. Shrinkage estimates for inventory accounting (sec. 961 of the Act and sec. 471 of the Code)

Present and Prior Law

Section 471(a) provides that "(w)henever in the opinion of the Secretary the use of inventories is necessary in order clearly to de-

termine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith.[181] The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as "shrinkage."

Some taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

If a physical inventory is taken at year-end, the amount of shrinkage for the year is known. If a physical inventory is not taken at year-end, shrinkage through year-end will have to be based on an estimate, or not taken into account until the following year. In the first decision in *Dayton Hudson* v. *Commissioner,*[182] the U.S. Tax Court held that a taxpayer's method of accounting may include the use of an estimate of shrinkage occurring through year-end, provided the method is sound and clearly reflects income. In the second decision in *Dayton Hudson* v. *Commissioner*,[183] the U.S. Tax Court adhered to this holding. However, the U.S. Tax Court in the second decision determined that this taxpayer had not established that its method of accounting clearly reflected income. Other cases decided by the U.S. Tax Court[184] have held that taxpayers' methods of accounting that included shrinkage estimates do clearly reflect income.

The U.S. Tax Court in the second *Dayton Hudson* opinion noted that "(i)n most cases, generally accepted accounting principles (GAAP), consistently applied, will pass muster for tax purposes. The Supreme Court has made clear, however, that GAAP does not enjoy a presumption of accuracy that must be rebutted by the Commissioner."

Reasons for Change

The Congress believed that inventories should be kept in a manner that clearly reflects income. The Congress also believed that it is inappropriate to require a physical count of a taxpayer's entire inventory to be taken exactly at year-end, provided that physical counts are taken on a regular and consistent basis. Where physical inventories are not taken at year-end, the Congress believed that income will be more clearly reflected if the taxpayer makes a reasonable estimate of the shrinkage occurring through year-end. In

[181] Treas. Reg. sec. 1.471–2(d).
[182] 101 T.C. 462 (1993).
[183] T.C. Memo 1997–260.
[184] *Wal-Mart* v. *Commissioner,* T.C. Memo 1997–1 and *Kroger* v. *Commissioner,* T.C. Memo 1997–2.

the case of retail trade inventories, the Congress believed that the availability of a safe harbor shrinkage calculation would facilitate the clear reflection of income.

The Congress believed that a taxpayer should have the opportunity to change its method of accounting to a method that keeps inventories using shrinkage estimates, so long as such method is sound and clearly reflects income.

Explanation of Provision

The Act provides that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer is required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer is required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

The Secretary of the Treasury is expected to issue guidance establishing one or more safe harbor methods for the estimation of inventory shrinkage that will be deemed to result in a clear reflection of income, provided such safe harbor method is consistently applied and the taxpayer's inventory methods otherwise satisfy the clear reflection of income standard.

For taxpayers primarily engaged in retail trade (the resale of personal property to the general public), Congress anticipates that a safe harbor method that will use a historical ratio of shrinkage to sales, multiplied by total sales between the date of the last physical inventory and year-end will be available, provided physical inventories are normally taken at each location at least annually. The Congress anticipates that this historical ratio will be based on the actual shrinkage established by all physical inventories taken during the most recent three taxable years and the sales for related periods. The historical ratio should be separately determined for each store or department in a store of the taxpayer. The historical ratio, or estimated shrinkage determined using the historical ratio, cannot be adjusted by judgmental or other factors (e.g., floors or caps). The Congress expects that estimated shrinkage determined in accordance with the consistent application of the safe harbor method will not be required to be recalculated, through a lookback adjustment or otherwise, to reflect the results of physical inventories taken after year-end.

In the case of a new store or department in a store that has not verified shrinkage by a physical inventory in each of the most recent three taxable years, it is anticipated that the historical ratio for that store or department will be the average of the historical ratios of the retailer's other stores or departments. Retailers using last in, first out (LIFO) methods of inventory are expected to be required to allocate shrinkage among their various inventory pools in a reasonable and consistent manner.

The Congress expects that the Secretary of the Treasury should provide procedures to allow an automatic election of such method

of accounting for a taxpayer's first taxable year ending after the date of enactment. It is expected that any adjustment required by section 481 as a result of the change in method of accounting generally will be taken into account over a period of four years.

Effective Date

The provision was effective for taxable years ending after the date of enactment (August 5, 1997).

A taxpayer is permitted to change its method of accounting by this section if the taxpayer is currently using a method that does not utilize estimates of inventory shrinkage and wishes to change to a method for inventories that includes shrinkage estimates based on physical inventories taken other than at year-end. Congress also anticipates that a taxpayer primarily engaged in retail trade will be permitted to change its method of accounting to the safe harbor method described herein, without regard to whether the taxpayer is currently using a method that utilizes estimates of inventory shrinkage. Changes made pursuant to this provision are treated as voluntary changes in method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury, provided the taxpayer changes to a permissible method of accounting (including the described safe harbor method, if the taxpayer is eligible). The period for taking into account any adjustment required under section 481 as a result of such a change in method is 4 years.

No inference is intended with regard to whether any particular method of accounting for inventories is permissible under prior law.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $7 million in 1998, $21 million in 1999, $23 million in 2000, $25 million in 2001, $27 million in 2002, $29 million in 2003, $31 million in 2004, $33 million in 2005, $35 million in 2006 and $37 million in 2007.

2. Treatment of workmen's compensation liability under rules for certain personal injury liability assignments (sec. 962 of the Act and sec. 130 of the Code)

Present and Prior Law

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater

than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness. Present and prior law provide a separate exclusion under section 104(a)(1) for the recipient of amounts received under workmen's compensation acts as compensation for personal injuries or sickness, but under prior law, a qualified assignment under section 130 did not include the assignment of a liability to make such payments.

Reasons for Change

Structured settlement arrangements are essentially conduit arrangements in which the assignor of a liability, the assignee (the structured settlement company) and the claimant (recipient of benefits) share the economic benefit of the exclusion from income provided under present law. The Congress understood that some workmen's compensation payments involve periodic payments (rather than lump sum payments). The Congress was persuaded that additional economic security would be provided to workmen's compensation claimants who receive periodic payments if the payments are made through a structured settlement arrangement, where the payor is generally subject to State insurance company regulation that is aimed at maintaining solvency of the company, in lieu of being made directly by self-insuring employers that may not be subject to comparable solvency-related regulation.

Explanation of Provision

The Act extends the exclusion for qualified assignments under Code section 130 to amounts assigned for assuming a liability to pay compensation under any workmen's compensation act. The provision requires that the assignee assume the liability from a person who is a party to the workmen's compensation claim, and requires that the periodic payment be excludable from the recipient's gross income under section 104(a)(1), in addition to the requirements of present law.

Effective Date

The provision is effective for workmen's compensation claims filed after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998, $2 million in 1999, $5 million in 2000, $8 million in 2001, $12 million in 2002, $17 million in 2003, $23 million in 2004, $29 million in 2005, $32 million in 2006, and $36 million in 2007.

3. Tax-exempt status for certain State workmen's compensation act companies (sec. 963 of the Act and sec. 501(c)(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 organization 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.

Reasons for Change

The Congress believed that eliminating uncertainty concerning the eligibility of certain State workmen's compensation act companies for tax-exempt status would assist States in ensuring workmen's compensation coverage for uninsured employers with respect to employees in the State. While tax exemption may have been available under prior law for many of these entities, the Congress believed that it was appropriate to clarify standards for tax-exempt status.

Explanation of Provision

The Act clarifies the tax-exempt status of any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance,[185] and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive rem-

[185] Related coverage that is incidental to workmen's compensation insurance includes liability under Federal workmen's compensation laws, the Jones Act, and the Longshore and Harbor Workers Compensation Act, for example.

edy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

No inference is intended that the benefit plans of organizations described in the provision are not properly maintained by the organization. It is anticipated that Federal regulatory agencies will take appropriate action to address transition issues faced by organizations to conform their benefit plans under the provision. For example, it is intended that an organization that has been maintaining a section 457 plan as an agency or instrumentality of a State could (without creating any inference with respect to prior-law treatment) freeze future contributions to the section 457 plan and establish a retirement arrangement (e.g., a section 401(k) plan) that is consistent with the treatment of the organization as a tax-exempt employer under the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997. Many organizations described in the provision have been operating as tax-exempt organizations. No inference is intended that organizations described in the provision are not tax-exempt under prior law.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in each of 1998 and 1999, and by $1 million per year in each of 2000 through 2007.

4. Election for 1987 partnerships to continue exception from treatment of publicly traded partnerships as corporations (sec. 964 of the Act and sec. 7704 of the Code)

Present and Prior Law

A publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704). An exception to the rule treating the partnership as a corporation applies if 90 percent of

the partnership's gross income consists of "passive-type income," which includes (1) interest (other than interest derived in a financial or insurance business, or certain amounts determined on the basis of income or profits), (2) dividends, (3) real property rents (as defined for purposes of the provision), (4) gain from the sale or other disposition of real property, (5) income and gains relating to minerals and natural resources (as defined for purposes of the provision), and (6) gain from the sale or disposition of a capital asset (or certain trade or business property) held for the production of income of the foregoing types (subject to an exception for certain commodities income).

The exception for publicly traded partnerships with "passive-type income" does not apply to any partnership that would be described in section 851(a) of the Code (relating to regulated investment companies, or "RICs"), if that partnership were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. Nevertheless, if a principal activity of the partnership consists of buying and selling of commodities (other than inventory or property held primarily for sale to customers) or futures, forwards and options with respect to commodities, and 90 percent of the partnership's income is such income, then the partnership is not treated as a corporation.

A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Treasury regulations provide detailed guidance as to when an interest is treated as readily tradable on a secondary market or the substantial equivalent. Generally, an interest is so treated "if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market" (Treas. Reg. sec. 1.7704–1(c)(1)).

When the publicly traded partnership rules were enacted in 1987, a 10-year grandfather rule provided that the provisions apply to certain existing partnerships only for taxable years beginning after December 31, 1997.[186] An existing publicly traded partnership is any partnership, if (1) it was a publicly traded partnership on December 17, 1987, (2) a registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, an application was filed with a State regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership. A partnership that otherwise would be treated as an existing publicly traded partnership ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A rule is provided to coordinate this grandfather rule with the exception to the rule treating the partnership as a corporation that

[186] Omnibus Budget Reconciliation Act of 1987 (P.L. 100–203), sec. 10211(c).

applies if 90 percent of the partnership's gross income consists of passive-type income. The coordination rule provides that passive-type income exception applies only after the grandfather rule ceases to apply (whether by passage of time or because the partnership ceases to qualify for the grandfather rule).

Reasons for Change

The Congress believed that, in important respects, publicly traded partnerships generally resemble corporations and should be subject to tax as corporations, so long as the current corporate income tax applies to corporate entities. Nevertheless, in the case of certain publicly traded partnerships that were existing on December 17, 1987, and that are treated as partnerships under the grandfather rule until December 31, 1997, it is appropriate to permit the continuation of their status as partnerships, so long as they elect to be subject to a tax that is intended to approximate the corporate tax they would pay if they were treated as corporations for Federal tax purposes.

Explanation of Provision

In the case of an electing 1987 partnership that elects to be subject to a tax on gross income from the active conduct of a trade or business, the rule of present law treating a publicly traded partnership as a corporation does not apply. An electing 1987 partnership means any publicly traded partnership, if (1) it is an existing partnership within the meaning of section 10211(c)(2) of the 1987 Act, (2) it has not been treated as a corporation for taxable years beginning after December 31, 1987, and before January 1, 1998 (and would not have been treated as a corporation even without regard to section 7704(c), the exception for partnerships with "passive-type" income), and (3) the partnership elects under the provision to be subject to a tax on gross income from the active conduct of a trade or business. An electing 1987 partnership ceases to be treated as such as of the first day after December 31, 1997, on which there has been the addition of a substantial new line of business with respect to the partnership. The election to be subject to the tax on gross trade or business income, once made, remains in effect until revoked by the partnership, and cannot be reinstated.

The tax is 3.5 percent of the partnership's gross income from the active conduct of a trade or business. The partnership's gross trade or business income includes its share of gross trade or business income of any lower-tier partnership. The tax imposed under the provision may not be offset by tax credits, by either the partnership or the partners; nor is the tax deductible by the partnership or the partners (sec. 275).

Effective Date

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

Revenue Effect

The provision is estimated neither to increase nor reduce Federal fiscal year budget receipts for the years 1998 through 2007.

5. Exclusion from UBIT for certain corporate sponsorship payments (sec. 965 of the Act and new sec. 513(i) of the Code)

Present and Prior Law

Although generally exempt from Federal income tax, tax-exempt organizations 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). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.[187] If a tax-exempt organization receives sponsorship payments in connection with an event or other activity, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments are subject to the UBIT.[188]

Reasons for Change

In order to reduce the uncertainty regarding the treatment for UBIT purposes of corporate sponsorship payments received by tax-exempt organizations, the Congress believed that it is appropriate to distinguish sponsorship payments for which the donor receives no substantial return benefit other than the use or acknowledgment of the donor's name or logo as part of a sponsored event (which should not be subject to the UBIT) from payments made in exchange for advertising provided by the recipient organization (which should be subject to the UBIT).

Explanation of Provision

Under the Act, qualified sponsorship payments received by a tax-exempt organization (or State college or university described in section 511(a)(2)(B)) are exempt from the UBIT.

"Qualified sponsorship payments" are defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities.[189] Such a use or acknowledgment does not in-

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[187] See *United States* v. *American College of Physicians,* 475 U.S. 834 (1986) (holding that the activity of selling advertising in a medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

[188] See Prop. Treas. Reg. sec. 1.513–4 (issued January 19, 1993, EE–74–92, IRB 1993–7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under which the tax-exempt organization provides so-called "institutional" or "good will" advertising.

[189] In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the organization's exempt purpose.

clude advertising of such person's products or services—meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment will not be subject to the UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising will be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are satisfied).[190]

The term "qualified sponsorship payment" does not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, will not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, will be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus will not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

The provision does not apply to payments that entitle the payor to the use or acknowledgment of the payor's trade or business name or logo (or product lines) in tax-exempt organization periodicals. Such payments are outside the qualified sponsorship payment provision's safe-harbor exclusion, and, therefore, will be governed by present-law rules that determine whether the payment is subject to the UBIT. Thus, for example, payments that entitle the payor to a depiction of the payor's name or logo in a tax-exempt organization periodical may or may not be subject to the UBIT depending on the application of present-law rules regarding periodical advertising and nontaxable donor recognition.[191] For this purpose, the term "periodical" means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a spe-

[190] As provided under Prop. Treas. Reg. sec. 1.513–4, the use of promotional logos or slogans that are an established part of the sponsor's identity would not, by itself, constitute advertising for purposes of determining whether a payment is a qualified sponsorship payment.

[191] For guidance regarding the treatment of periodical advertising under the UBIT, see section 513(c), *United States* v. *American College of Physicians,* 475 U.S. 834 (1986); Treas. Reg. 1.513–1(d)(4)(iv), Example 7; Rev. Rul. 82–139, 1982–2 C.B. 108; Rev. Rul. 74–38, 1974–1 C.B. 144; PLR 9137049; and PLR 9234002. For guidance regarding the treatment of donor acknowledgments under the UBIT, see Rev. Rul. 76–93, 1976–1 C.B. 170; PLR 8749085; and PLR 9044071. In the interest of administrative convenience, the Treasury Department is encouraged to permit tax-exempt entities to provide combined reporting of payments that are both qualified sponsorship payments and nontaxable payments made in exchange for donor acknowledgments in a periodical or in connection with a qualified convention or trade show. In addition, to the extent tax-exempt entities are required to allocate portions of payments, the Treasury Department is encouraged to minimize the reporting burden associated with any such allocation.

cific event conducted by the payee organization.[192] In addition, the safe-harbor exclusion provided for by the provision does not apply to payments made in connection with "qualified convention or trade show activities," as defined in present-law section 513(d)(3).

The provision specifically provides that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment will be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising *and* use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT will not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) in connection with a sponsorship payment will not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services will be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities will not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees (complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) will be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise will be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

The exemption provided by the provision will be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference is intended as to whether any sponsorship payment received prior to 1998 was subject to the UBIT.

Effective Date

The provision applies to qualified sponsorship payments solicited or received after December 31, 1997.

Revenue Effect

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

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[192] For example, the provision will not apply to payments that lead to acknowledgments in a monthly journal, but will apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event.

6. Timeshare associations (sec. 966 of the Act and sec 528 of the Code)

Present and Prior Law

Taxation of homeowners associations making the section 528 election

Under present law (sec. 528), condominium management associations and residential real estate management associations may elect to be taxed at a 30-percent rate on their "homeowners association income" if they meet certain income, expenditure, and organizational requirements.

"Homeowners association income" is the excess of the association's gross income, excluding "exempt function income," over allowable deductions directly connected with non-exempt function gross income. "Exempt function income" includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners association income includes passive income (e.g., interest and dividends) earned on reserves and fees for use of association property (e.g., swimming pools, meeting rooms, etc.).

For an association to qualify for this treatment: (1) at least 60 percent of the association's gross income must consist of membership dues, fees, or assessments on owners; (2) at least 90 percent of its expenditures must be for the acquisition, management, maintenance, or care of "association property;" and (3) no part of its net earnings can inure to the benefit of any private shareholder. "Association property" means: (1) property held by the association; (2) property commonly held by association members; (3) property within the association privately held by association members; and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons less than 30 days for more than half of the association's taxable year. Treas. Reg. sec. 1.528–4(d).

Taxation of homeowners associations not making the section 528 election

Homeowners associations that do not (or cannot) make the section 528 election are taxed either as tax-exempt social welfare organizations under section 501(c)(4) or as regular C corporations. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public (Rev. Rul. 74–99, 1974–1 C.B. 131).

Non-exempt homeowners associations are taxed as C corporations, except that: (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments (Rev. Rul. 70–604, 1970–2 C.B. 9); (2) gross income does not include special assessments held in a special bank account (Rev. Rul. 75–370, 75–2 C.B. 25); and (3) assessments for capital improvements are treated as non-taxable contributions to capital (Rev. Rul. 75–370, 1975–2 C.B. 25).

Taxation of timeshare associations

Under prior law, timeshare associations are taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74–99 for tax-exempt status under section 501(c)(4).

Reasons for Change

The Congress understood that the IRS recently had challenged the exclusions from gross income of timeshare associations of refunds of excess assessments, special assessments held in a segregated account, and capital assessments as contributions to capital. See P.L.R. 9539001 (June 8, 1995). The Congress believed that the activities of timeshare associations are sufficiently similar to those of homeowners associations that they should be similarly taxed. Accordingly, the Act extends the rules for the taxation of homeowners associations to timeshare associations, except that the rate of tax on timeshare associations is 32 percent, instead of the 30-percent rate that applies to homeowner's associations.

Explanation of Provision

In general

The Act amends section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations will have to meet the requirements of section 528 (e.g., the 60-percent gross income, 90-percent expenditure, and the non-profit organizational and operational requirements). Timeshare associations electing to be taxed under section 528 are subject to a tax on their "timeshare association income" at a rate of 32 percent.

60-percent test

A qualified timeshare association must receive at least 60 percent of its income from membership dues, fees and assessments from owners of either (a) timeshare rights to use of, or (b) timeshare ownership in, property of the timeshare association.

90-percent test

At least 90 percent of the expenditures of the timeshare association must be for the acquisition, management, maintenance, or care of "association property," and activities provided by the association to, or on behalf of, members of the timeshare association. "Activi-

ties provided to or on behalf of members of the [timeshare] association" include events located on association property (e.g., members' meetings at the association's meeting room, parties at the association's swimming pool, golf lessons on association's golf range, transportation to and from association property, etc.). Association property includes property in which a timeshare association or members of the association have rights arising out of recorded easements, covenants, and other recorded instruments to use property related to the timeshare project.

Organizational and operational tests

No part of the net earnings of the timeshare association can inure to the benefit (other than by acquiring, constructing, or providing management, maintenance, and care of property of the timeshare association or rebate of excess membership dues, fees, or assessments) of any private shareholder or individual. A member of a qualified timeshare association must hold a timeshare right to use (or timeshare ownership in) real property of the association. A qualified timeshare association cannot be a condominium management association. Lastly, the timeshare association must elect to be taxed under section 528.

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 $1 million in each of the years 1998 through 2001 and by $2 million for each of the years 2002 through 2007.

7. Modification of advance refunding rules for certain tax-exempt bonds issued by the Virgin Islands (sec. 967 of the Act and sec. 149 of the Code)

Present and Prior Law

In general

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private

activity bonds) for the interest on these bonds to be excluded from gross income.

Advance refundings

Generally, a governmental bond originally issued after December 31, 1985, may be advance refunded one time. An advance refunding is any refunding where all of the refunded bonds are not redeemed within 90 days after the refunding bonds are issued. Private activity bonds may not be advance refunded.

Virgin Island bonds

Under prior law, the Virgin Islands was required to secure its bonds with a priority first lien claim on specified revenue streams rather than being permitted to issue multiple bond issues secured on a parity basis by a common pool of revenues. Under a recent non-tax law change, the priority lien requirement was repealed.

Reasons for Change

The Congress believed that allowing an additional advance refunding is appropriate to accommodate made changes to other, nontax Federal restrictions on these bonds.

Explanation of Provision

Under the Act, one additional advance refunding is allowed for governmental bonds issued by the Virgin Islands that were advance refunded before June 9, 1997.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $4 million in 1999, $5 million in 2000, $5 million in 2001, $5 million in 2002, $3 million in 2003, $1 million in 2004, $3 million in 2005, $4 million in 2006, and $4 million in 2007.

8. Deferral of gain on certain sales of farm product refiners and processors (sec. 968 of the Act (canceled pursuant to Line Item Veto Act) and sec. 1042 of the Code)

Present and Prior Law

Under present law, if certain requirements are satisfied, a taxpayer may defer recognition of gain on the sale of qualified securities to an employee stock ownership plan ("ESOP") or an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property (sec. 1042). Gain is recognized when the taxpayer disposes of the qualified replacement property. One of the requirements that must be satisfied for deferral to apply is that, immediately after the sale, the ESOP must own at least 30 percent of the stock of the corporation issuing the

qualified securities. In general, qualified securities are securities issued by a domestic C corporation that has no stock outstanding that is readily tradeable on an established securities market. Deferral treatment does not apply to gain on the sale of qualified securities by a C corporation.

Reasons for Change

The Congress understood that much of the final value of farm products often is generated not in their production on the farm, but during the processing or refining of farm products after those products leave the farm. The Congress believed that, in order for farmers to share more of that final value, farmers must directly or indirectly own some of the processing or refining facilities. The Congress believed it appropriate to facilitate the transfer of refiners and processors to farmers' cooperatives by providing for the tax-free rollover of gain on the sale of stock of a corporation that owns farm product processing or refining facilities if the stock was sold to a cooperative which was selling farm produce for refining or processing in those facilities.

Explanation of Canceled Provision

As passed by Congress, the Act extended the deferral provided under section 1042 to the sale of stock of a qualified refiner or processor to an eligible farmers' cooperative. A qualified refiner or processor is a domestic corporation substantially all of the activities of which consist of the active conduct of the trade or business of refining or processing agricultural or horticultural products and which purchases more than one-half of the products to be refined or processed from farmers who make up the cooperative (or the cooperative itself) which is purchasing the stock for at least one year prior to the sale. An eligible farmers' cooperative is an organization which is treated as a cooperative for Federal income tax purposes and which is engaged in the marketing of agricultural or horticultural products.

The deferral of gain is available only if, immediately after the sale, the eligible farmers' cooperative owns 100 percent of the qualified refiner or processor. The provision applies even if the stock of the qualified refiner or processor is publicly traded. In addition, the provision applies to gain on the sale of stock by a C corporation.

Effective Date

The provision would have applied to sales after December 31, 1997.

Revenue Effect

The provision was estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $68 million in 1999, $5 million per year in 2000 and 2001, and $4 million per year in each of the years 2002 through 2007.

Effect of Line Item Veto

This provision was identified by the Joint Committee on Taxation as a limited tax benefit within the meaning of the Line Item Veto Act. The President canceled this provision pursuant to the Line Item Veto Act.[193]

9. Increased deduction for business meals while operating under Department of Transportation hours of service limitations (sec. 969 of the Act and sec. 274 of the Code)

Present and Prior Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for food and beverage is limited to 50 percent of the otherwise deductible amount. Exceptions to this 50 percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs.

Reasons for Change

Individuals subject to the hours of service limitations of the Department of Transportation are frequently forced to eat meals away from home in circumstances where their choice is limited, prices comparatively high and the opportunity for lavish meals remote. The Congress believed that it is appropriate to allow a higher percentage of the cost of food and beverages consumed while away from home on business by these individuals to be deducted than is allowed under the general rule.

Explanation of Provision

The Act increased to 80 percent the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation.

Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,

(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,

(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and

(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

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[193] A modified version of this provision is included in H.R. 2513 as passed by the House on November 8, 1997. (See report of the House Committee on Ways and Means; H. Rept. 105–318, Part I, October 9, 1997).

Taxable years beginning in—	*Deductible percentage*
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

Effective Date

The provision is effective for taxable years beginning after 1997.

Revenue Effect

This provision and Act sec. 970 (described following) are estimated to reduce Federal fiscal year budget receipts by $8 million in 1998, $17 million in 1999, $27 million in 2000, $37 million in 2001, $49 million in 2002, $62 million in 2003, $76 million in 2004, $91 million in 2005, $108 million in 2006 and $125 million in 2007.

10. Deductibility of meals provided for the convenience of the employer (sec. 970 of the Act and sec. 132 of the Code)

Present and Prior Law

In general, subject to several exceptions, only 50 percent of business meal and entertainment expenses are allowed as a deduction (sec. 274(n)). Under one exception, the value of meals that are excludable from employees' incomes as a de minimis fringe benefit (sec. 132) are fully deductible by the employer.

In addition, the courts that have considered the issue have held that if meals are provided for the convenience of the employer pursuant to section 119 they are fully deductible pursuant to sec. 274(n)(2)(B), provided they satisfy the relevant section 132 requirements (*Boyd Gaming Corp. v. Commissioner*[194] and *Gold Coast Hotel & Casino v. I.R.S.*[195]).

Reasons for Change

The Congress believed that it is consistent with the case law to provide for full deductibility of business meals that are excludible from employees' incomes because they are provided for the convenience of the employer.

Explanation of Provision

The Act provides that meals that are excludable from employees' incomes because they are provided for the convenience of the employer pursuant to section 119 of the Code, provided they satisfy the relevant section 132 requirements, are excludable as a de minimis fringe benefit and therefore are fully deductible by the em-

[194] 106 T.C. 343 (1996).
[195] U.S. D.C. Nev. CV–5–94–1146–HDM (LRL) (September 26, 1996).

ployer. No inference is intended as to whether such meals are fully deductible under present law.

Effective Date

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

Revenue Effect

The effect of this provision on Federal fiscal year budget receipts is included in the estimate of the effect of the provision allowing an increased deduction for business meals while operating under Department of Transportation hours of service limitations (Act sec. 969, above).

11. Modify limits on depreciation of luxury automobiles for certain clean-burning fuel and electric vehicles (sec. 971 of the Act and sec. 280F of the Code)

Present and Prior Law

The amount the taxpayer may claim as a depreciation deduction for any passenger automobile is limited to: $2,560 for the first taxable year in the recovery period; $4,100 for the second taxable year in the recovery period; $2,450 for the third taxable year in the recovery period; and $1,475 for each succeeding taxable year in the recovery period. Each of the dollar limitations is indexed for inflation after October 1987 by the automobile component of the Consumer Price Index. Consequently, the depreciation deduction limitations applicable for 1997 are $3,160, $5,000, $3,050, and $1,775.

Reasons for Change

The Congress believed that the price of a clean-burning fuel vehicle or an electric vehicle does not necessarily represent the consumer's purchase of a luxury automobile. Rather, the higher price of such vehicles often represents the cost of the technology required to produce an automobile designed to provide certain environmental benefits. The Congress believed the cost of this technology should not be considered a luxury for the purpose of the limitation on depreciation that may be claimed on passenger automobiles. Therefore, the Congress believed it is appropriate to modify the limitation on depreciation that may be claimed on passenger automobiles in the case of certain clean-burning fuel vehicles and electric vehicles.

Explanation of Provision

The Act modifies the limitation on depreciation in the case of qualified clean-burning fuel vehicles and certain electric vehicles. With respect to qualified clean-burning fuel vehicles, those that are modified to permit such vehicles to be propelled by a clean burning fuel, the Act generally applies the limitation to that portion of the vehicles' cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise al-

lowable as a depreciation deduction on the installed qualified clean-burning fuel property, without regard to the limitation. Generally, this has the same effect as only subjecting the cost of the vehicle before modification to the limitations.

In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the base-year limitation amounts of $2,560 for the first taxable year in the recovery period, $4,100 for the second taxable year in the recovery period, $2,450 for the third taxable year in the recovery period, and $1,475 for each succeeding taxable year in the recovery period are tripled to $7,680, $12,300, $7,350, and $4,425, respectively, and then adjusted for inflation after October 1987 by the automobile component of the Consumer Price Index.

Effective Date

The provision is effective for property placed in service after the date of enactment (August 5, 1997) and before January 1, 2005.

Revenue Effect

The provision is estimated to result in a negligible reduction in Federal fiscal year budget receipts for years 1997 through 2007.

12. Temporary suspension of income limitations on percentage depletion for production from marginal wells (sec. 972 of the Act and sec. 613A of the Code)

Present and Prior Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100 percent of the net income from that property in any year (sec. 613(a)).

Specific percentage depletion rules apply to oil and gas production from "marginal" properties (sec. 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

Reasons for Change

The Congress believed that a temporary suspension of the net income property limitation for marginal oil and gas production was an appropriate part of overall national energy security policy.

Explanation of Provision

The 100-percent-of-net-income property limitation is suspended for domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $21 million in 1998, $35 million in 1999, and $14 million in 2000.

13. Increase in standard mileage rate for purposes of computing charitable deduction (sec. 973 of the Act and sec. 170(I) of the Code)

Present and Prior Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may constitute a deductible contribution (Treas. Reg. sec. 1.170A–1(g)).[196] However, no charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (sec. 170(j)). Moreover, a taxpayer may not deduct as a charitable contribution out-of-pocket expenditures incurred on behalf of a charity if such expenditures are made for the purposes of influencing legislation (sec. 170(f)(6)).

Under prior law, for purposes of computing the charitable contribution deduction for the use of a passenger automobile (including vans, pickups, and panel trucks) in connection with rendering donated services to a qualified charitable organization, the standard mileage rate was 12 cents per mile (sec. 170(i)).

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[196] Treasury Regulation section 1.170A–1(g) allows taxpayers to deduct only their own unreimbursed expenses incurred in performing services for a qualified charitable organization, and not expenses incident to a third party's performance of services. See *Davis v. United States,* 495 U.S. 472 (1990).

Reasons for Change

The Congress believed that it is appropriate to increase the standard mileage rate for purposes of the charitable contribution deduction.

Explanation of Provision

For purposes of computing the charitable contribution deduction for the use of a passenger automobile in connection with rendering donated services to a qualified charitable organization, the standard mileage rate is increased to 14 cents per mile.

As an alternative to claiming the standard mileage rate, taxpayers will continue to have the option of claiming a deduction for actual out-of-pocket transportation expenses necessarily incurred in performing donated services (i.e., operating expenses for use of an automobile, but not general maintenance, depreciation, or insurance costs), provided that the taxpayer maintains adequate records or other evidence for substantiation. See Rev. Proc. 96–63, 1996–2 C.B. 420. Parking fees and tolls attributable to the use of an automobile for charitable purposes may be deducted as separate items. *Id.*

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1998, $56 million in 1999, $58 million in 2000, $61 million in 2001, $64 million in 2002, $68 million in 2003, $71 million in 2004, $75 million in 2005, $78 million in 2006, and $82 million in 2007.

14. Purchases of receivables by tax-exempt hospital cooperative service organizations (sec. 974 of the Act and sec. 501(e) of the Code)

Present and Prior Law

Section 501(e) provides that an organization organized on a cooperative basis by tax-exempt hospitals will itself be tax-exempt if the organization is operated solely to perform, on a centralized basis, one or more of certain enumerated services for its members. These services are: data processing, purchasing (including the purchase of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services. An organization does not qualify under section 501(e) if it performs services other than the enumerated services. (Treas. Reg. sec. 1.501(e)–1(c)).

Reasons for Change

The Congress believed that it is important to clarify that permissible billing and collection services that can be carried out by hos-

pital cooperative service organizations under section 501(e) include the purchase of patron accounts receivable on a recourse basis.

Explanation of Provision

The Act clarifies that, for purposes of section 501(e), billing and collection services include the purchase of patron accounts receivable on a recourse basis. Thus, hospital cooperative service organizations are permitted to advance cash on the basis of member accounts receivable, provided that each member hospital retains the risk of non-payment with respect to its accounts receivable.

Effective Date

The provision is effective for taxable years beginning after December 31, 1996. No inference is intended with respect to taxable years prior to the effective date.

Revenue Effect

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts in each of 1997 through 2007.

15. Provide above-the-line deduction for certain business expenses in connection with service performed by certain officials (sec. 975 of the Act and sec. 62 of the Code)

Present and Prior Law

Under present and prior law, individuals may generally deduct ordinary and necessary business expenses in determining adjusted gross income ("AGI"). Under prior law, this deduction did not apply in the case of any individual performing services as an employee. Employee business expenses generally were deductible only as a miscellaneous itemized deduction, i.e., only to the extent all the taxpayer's miscellaneous itemized deductions exceed 2 percent of the taxpayer's AGI. Employee business expenses were not allowed as a deduction for alternative minimum tax purposes.

Reasons for Change

The Congress was aware that certain State and local government officials are compensated (in whole or in part) on a fee basis to provide certain services to the government. These officials hire employees and incur expenses in connection with their official duties. These expenses may be subject, under prior law, to the 2-percent floor on itemized deductions. The Congress believed these expenses should be deductible.

Explanation of Provision

Under the Act, employee business expenses relating to service as an official of a State or local government (or political subdivision thereof) are deductible in computing AGI ("above the line"), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for minimum tax purposes.

Effective Date

The provision applies to expenses paid or incurred in taxable years beginning after December 31, 1986.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $10 million in 1998, $4 million in 1999, $4 million in 2000, $4 million in 2001, $5 million in 2002, $5 million in 2003, $6 million in 2004, $6 million in 2005, $7 million in 2006, and $7 million in 2007.

16. Combined employment tax reporting demonstration project (sec. 976 of the Act)

Present and Prior Law

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

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 Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Implementation of the combined Montana-Federal employment tax reporting project has been hindered because section 6103 can be interpreted to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not apply to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

Reasons for Change

The Congress believed that it is appropriate to permit a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future.

Explanation of Provision

The Act permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project. First, it is limited to the State of Montana and the IRS. Second, it is limited to employment tax reporting. Third, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it is limited to a period of five years.

The Congress intended that the State of Montana be allowed to use the data collected through the demonstration project as if it had collected it separately.[197]

Effective Date

The provision was effective on the date of enactment (August 5, 1997), and will expire on the date five years after the date of enactment (August 5, 2002).

Revenue Effect

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

17. Elective carryback of existing net operating losses of the National Railroad Passenger Corporation (Amtrak) (sec. 977 of the Act)

Present and Prior Law

Generally, under prior law, net operating losses could be carried back to the three taxable years of the taxpayer that precede the year of loss (10 taxable years in certain circumstances). Section 1082 of the Act limits this carryback period to two years for losses arising in taxable years beginning after August 5, 1997.

Reasons for Change

The Congress believed that the provision of viable intercity passenger rail service by Amtrak is an important national objective. At present, that objective is threatened by capital needs of Amtrak, the principal passenger rail service provider.

Explanation of Provision

The Act provides elective procedures that allow Amtrak to consider the tax attributes of its predecessors, those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970, in the use of Amtrak's net operating losses. The benefit allowable under these procedures is limited to the least of: (1) 35 percent of Amtrak's existing qualified carryovers, (2) the net tax liability for

[197] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 608(c)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

the carryback period, or (3) $2,323,000,000. One half of the amount so calculated will be treated as a payment of the tax imposed by chapter 1 of the Internal Revenue Code of 1986 for the Amtrak's taxable year ending December 31, 1997, and a similar amount for Amtrak's taxable year ending December 31, 1998.

The existing qualified carryovers are the net operating loss carryovers that are available under section 172(b) in Amtrak's first taxable year ending after September 30, 1997. The net tax liability for the carryback period is the aggregate of the net tax liability of Amtrak's railroad predecessors for all taxable years beginning before January 1, 1971, for which there is a net Federal tax liability. Amtrak's railroad predecessors are those railroads that were relieved of their responsibility to provide intercity rail passenger service as a result of the Rail Passenger Service Act of 1970, and their predecessors. In the case of a railroad predecessor who joined in the filing of a consolidated tax return, the net tax liability of the predecessor will be the net tax liability of the consolidated group.

The net operating losses of Amtrak are required to be reduced by an amount equal to the amount obtained by Amtrak under this provision, divided by 0.35. The Secretary of the Treasury is to adjust, as he deems appropriate, the tax account of each predecessor railroad for the carryback period to reflect the utilization of the net operating losses. The amount of the adjustment is equal to the amount of the benefit and is to be taken into consideration on the tax accounts of the predecessor railroads on a first-in, first-out basis, starting with balances for the earliest year for which any predecessor railroad has a net tax liability. No additional refund to any taxpayer other than Amtrak is to be allowed as a result of these adjustments.

The availability of the elective procedures is conditioned on Amtrak (1) agreeing to make payments of one percent of the amount it receives to each of the non-Amtrak States to offset certain transportation related expenditures and (2) using the balance for certain qualified expenses. Non-Amtrak States are those States that are not receiving Amtrak service at any time during the period beginning on the date of enactment and ending on the date of payment.

No deduction is allowed with respect to any qualified expense whose payment is attributable to the proceeds made available as a result of this provision. The basis of any property must be reduced by the portion of its cost that is attributable to such proceeds. An item of cost or expense is attributable to such proceeds if it is (1) paid from the proceeds of the refund or (2) to the extent the principal and interest of any borrowings are paid from the proceeds of the refund, from the proceeds of such borrowings.

Amtrak's earnings and profits will be increased by the amount of the refund. However, Congress expects that this amount will not be included in adjusted current earnings for alternative minimum tax purposes, consistent with Treas. Reg. sec. 1.56(g)–1(c)(4) (ii).

Effective Date

The provision was effective on the date of enactment (August 5, 1997). However, no refund shall be made as a result of this provision earlier than the date of enactment of Federal legislation which

authorizes reforms of Amtrak.[198] No interest shall accrue with respect to the payment of any refund due as a result of this provision until 45 days after the latest of (1) the enactment of such reform legislation, (2) the filing by Amtrak of a Federal income tax return which includes the election to use the procedures described in this provision, or (3) the original due date of such return.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1,162 million in 1998 and $1,162 million in 1999.

H. Extension of Duty-Free Treatment Under Generalized System of Preferences (sec. 981 of the Act and sec. 505 of the Trade Act of 1974)

Prior Law

Title V of the Trade Act of 1974, as amended (Generalized System of Preferences) ("GSP"), grants authority to the President to provide duty-free treatment on imports of eligible articles from designated beneficiary developing countries, subject to specific conditions and limitations. To qualify for GSP privileges each beneficiary country is subject to various mandatory and discretionary eligibility criteria. Import sensitive products are ineligible for GSP. The President's authority to grant GSP benefits expired after May 31, 1997.

Reasons for Change

The GSP program promotes three broad policy goals: (1) to foster economic development in developing economies and economies in transition through increased trade, rather than foreign aid; (2) to promote U.S. trade interests by encouraging beneficiaries to open their markets and comply more fully with international trading rules; and (3) to help maintain U.S. international competitiveness by lowering costs for U.S. business, as well as lowering prices for American consumers. Recent short-term extensions of the program have been highly disruptive to U.S. companies who rely on GSP products, and to the economic development of beneficiary countries. Budgetary effects of the program, however, precluded a longer term extension. So that there will be no gap in duty-free treatment, the provision provides for an extension that is retroactive to May 31, 1997, through a refund procedure upon request of an importer.

Explanation of Provision

The Act reauthorizes the GSP program for 13 months, to expire after June 30, 1998. The provision provides for refunds, upon request of the importer, of any duty paid between May 31, 1997 and the date of enactment.

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[198] Section 301(b) of the Amtrak Reform and Accountability Act of 1997 (P.L. 105–134), passed by the House and Senate on November 13, 1997 and signed by the President on December 2, 1997, states that such Act constitutes Amtrak reform legislation within the meaning of this provision.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $378 million in 1998, and to have no revenue effect in fiscal years 1999 through 2007.

TITLE X. REVENUE-INCREASE PROVISIONS

A. Financial Products

1. Require recognition of gain on certain appreciated financial positions in personal property (sec. 1001(a) of the Act and sec. 1259 of the Code)

Present and Prior Law

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices generally is determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender), no gain or loss on the transaction is recognized until the closing of the borrowing.

Under prior law, transactions designed to reduce or eliminate risk of loss on financial assets generally did not cause realization. For example, a taxpayer could lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owned securities that were the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction was respected for income tax purposes and gain on the substantially identical property was not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer could obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it was time to close out the borrowing, the taxpayer could choose to deliver either the securities held or newly-purchased securities. The Code provided rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss (sec. 1233(b)).

Taxpayers also can lock in gain on certain property by entering into offsetting positions in the same or similar property. Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on the offsetting positions in a straddle (sec. 1092).

Taxpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "equity swaps" and other "notional principal contracts" where the risk of loss and opportunity for gain with respect to property are shifted to another party (the

"counterparty"). Under prior law, these arrangements did not result in the recognition of gain by the taxpayer.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term gain and 60 percent long-term gain (sec. 1256).

Reasons for Change

In general, a taxpayer cannot completely eliminate risk of loss (and opportunity for gain) with respect to property without disposing of the property in a taxable transaction. In recent years, however, several financial transactions have been developed or popularized which allow taxpayers to substantially reduce or eliminate their risk of loss (and opportunity for gain). Like most taxable dispositions, many of these transactions also provide the taxpayer with cash or other property in return for the interest that the taxpayer has given up.

One of these transactions is the "short sale against the box." In such a transaction, a taxpayer borrows and sells shares identical to the shares the taxpayer holds. By holding two precisely offsetting positions, the taxpayer is insulated from economic fluctuations in the value of the stock. While the short against the box is in place, the taxpayer generally can borrow a substantial portion of the value of the appreciated stock so that, economically, the transaction strongly resembles a sale of the long stock.

Other transactions that have been used by taxpayers to transfer risk of loss (and opportunity for gain) involve entering into notional principal contracts or futures or forward contracts to deliver the same stock. For example, a taxpayer holding appreciated stock may enter into an "equity swap" which requires the taxpayer to make payments equal to the dividends and any increase in the stock's value for a specified period, and entitles the taxpayer to receive payments equal to any depreciation in value. The terms of such swaps also frequently entitle the shareholder to receive payments during the swap period of a market rate of return (e.g., the Treasury-bill rate) on a notional principal amount equal to the value of the shareholder's appreciated stock, making the transaction strongly resemble a taxable exchange of the appreciated stock for an interest-bearing asset.

Explanation of Provision

General rules

The Act requires a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the constructive sale.

If the requirements for a constructive sale are met, the taxpayer recognizes gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. Except as provided in Treasury regulations, a con-

structive sale generally is not treated as a sale for other Code purposes; an appropriate adjustment in the basis of the appreciated financial position is made in the amount of any gain recognized on a constructive sale, and a new holding period of such position begins as if the taxpayer had acquired the position on the date of the constructive sale.

A taxpayer is treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same property, (2) enters into an offsetting notional principal contract with respect to the same property, or (3) enters into a futures or forward contract to deliver the same property. A constructive sale under any part of the definition occurs if the two positions are in property that, although not the same, is substantially identical. In addition, in the case of an appreciated financial position that is a short sale, a notional principal contract or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same property as the underlying property for the position. Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

Whether any part of the constructive sale definition is met by one or more appreciated financial positions and offsetting transactions generally will be determined as of the date the last of such positions or transactions is entered into. The positions of two related persons are treated as together resulting in a constructive sale if the relationship is one described in section 267 or section 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

The Act provides an exception from constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into (the "extended taxable year"). The exception is available only if (1) the taxpayer holds the appreciated financial position to which the transaction relates (e.g., the stock where the offsetting transaction is a short sale) throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the taxpayer's risk of loss reduced (under the principles of section 246(c)(4)) by holding positions with respect to substantially similar or related property. These requirements do not apply to a transaction that is closed during the extended taxable year where a substantially similar transaction is reopened during the 60-day period beginning on the closing date, so long as the reopened transaction is closed during the extended taxable year and the requirements of the previous sentence are met after such closing.

A transaction that has resulted in a constructive sale of an appreciated financial position (e.g., a short sale) is not treated as resulting in a constructive sale of another appreciated financial position so long as the taxpayer holds the position which was treated as constructively sold. However, when that position is assigned, terminated or disposed of by the taxpayer, the taxpayer immediately thereafter is treated as entering into the transaction that

resulted in the constructive sale (e.g., the short sale) if it remains open at that time. Thus, the transaction can cause a constructive sale of another appreciated financial position at any time thereafter. For example, assume a taxpayer holds two appreciated stock positions and one offsetting short sale, and the taxpayer identifies the short sale as offsetting one of the stock positions. If the taxpayer then sells the stock position that was identified, the identified short position would cause a constructive sale of the taxpayer's other stock position at that time.

Definitions

An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest, if there would be gain upon a taxable disposition of the position for its fair market value. A "position" is defined as an interest, including a futures or forward contract, short sale, or option. The Congress intended that a "position" include a notional principal contract or other derivative instrument that provides that a taxpayer make or receive payments (or contractual credits) that approximate the economic effect of ownership of stock, a debt instrument or a partnership interest. For example, a contract that provides a right to receive payments (or contractual credits) based on a calculation having the effect of interest on a notional principal amount will be treated as a position with respect to a debt instrument.

An appreciated financial position does not include a position with respect to a debt instrument that has an unconditionally payable principal amount, that is not convertible into the stock of the issuer or a related person, and the interest on which is either fixed, payable at certain variable rates (Treas. reg. sec. 1.860G–1(a)(3)) or based on certain interest payments on a pool of mortgages. A position that is a hedge of a position that meets these requirements also qualifies for this exception.[199] A hedge for this purpose includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuation with respect to another position. Other debt positions, including those identified as part of a hedging or straddle transaction, can be appreciated financial positions.

A trust instrument that is actively traded is generally treated as stock for purposes of determining whether the instrument is an appreciated financial position. However, an exception provides that a trust instrument will not be treated as stock if substantially all (by value) of the property held by the trust is debt that qualifies for the exception for certain debt positions described above.

A notional principal contract is treated as an offsetting notional principal contract, and thus results in a constructive sale of an appreciated financial position, if it requires the holder of the appreciated financial position to pay (or provide a contractual credit for) all or substantially all of the investment yield and appreciation on the position for a specified period and also gives the holder a right to be reimbursed for (or receive credit for) all or substantially all of any decline in value of the position.

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[199] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(a)(1)) of H.R. 2676, the Tax Technical Corrections Act of 1997, passed by the House on November 5, 1997.

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed amount of property and a substantially fixed price.[200] Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale. The Congress did not intend that an agreement that is not a contract for purposes of applicable contract law, or which is subject to very substantial contingencies, will be treated as a forward contract.

Special rules

A constructive sale does not include a transaction involving an appreciated financial position that is marked to market, including positions governed by section 475 (mark to market for securities and commodities dealers and traders) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f)) if the contract settles within one year after the date it is entered into.

More than one appreciated financial position or more than one offsetting transaction can be aggregated to determine whether a constructive sale has occurred. For example, it is possible that no constructive sale would result if one appreciated financial position and one offsetting transaction were considered in isolation, but that a constructive sale would result if the appreciated financial position were considered in combination with two transactions. Where the standard for a constructive sale is met with respect to only a *pro rata* portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion will be treated as constructively sold under the provision. If there is a constructive sale of less than all of any type of property held by the taxpayer, the specific property deemed sold will be determined under the rules governing actual sales, after adjusting for previous constructive sales under the Act. Under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or an offsetting transaction might in some circumstances be treated as disaggregated on a non-*pro rata* basis for purposes of the constructive sale determination. The Congress intended that this authority be used only where such disaggregated treatment reflects the economic reality of the transaction and is administratively feasible. For example, one transaction for which disaggregated treatment might be appropriate is an equity swap that references a small group of stocks, where the transaction is entered into by a taxpayer owning only one of the stocks.[201]

The Congress intended that the constructive sale provision generally will apply to transactions that are identified hedging or straddle transactions under other Code provisions (secs. 1092

[200] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(a)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, passed by the House on November 5, 1997.

[201] A standard similar to that of Treas. reg. sec. 1.246–5 would be appropriate for determining whether the relationship between the stock held and the group of stocks shorted is sufficient for constructive sale purposes.

(a)(2), (b)(2) and (e), 1221 and 1256(e)). Where either position in such an identified transaction is an appreciated financial position and a constructive sale of such position results from acquiring the other position, the Congress intended that the constructive sale will be treated as having occurred immediately before the identified transaction. The constructive sale will not, however, prevent qualification of the transaction as an identified hedging or straddle transaction. Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain will generally be recognized and accounted for under the relevant hedging or straddle provision. However, the Congress intended that future Treasury regulations may except certain transactions from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision (e.g. Treas. reg. sec. 1.446–4(b)).

Treasury guidance

The Act provides regulatory authority to the Treasury to treat as constructive sales certain transactions that have substantially the same effect as those specified (i.e., short sales, offsetting notional principal contracts and futures or forward contracts to deliver the same or substantially similar property).

The Congress anticipated that future Treasury regulations will treat as constructive sales other financial transactions that, like those specified in the provision, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain with respect to the appreciated financial position. Because this standard requires reduction of both risk of loss and opportunity for gain, the Congress intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered. Thus, for example, the Congress did not intend that a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (an "at the money" option). Because such an option reduces only the taxpayer's risk of loss, and not its opportunity for gain, the above standard would not be met.

The Congress did not intend that risk of loss and opportunity for gain be considered separately for purposes of the provision. Thus, if a transaction has the effect of eliminating a *portion* of the taxpayer's risk of loss and a *portion* of the taxpayer's opportunity for gain with respect to an appreciated financial position which, taken together, are substantially all of the taxpayer's risk of loss and opportunity for gain, the Congress intended that Treasury regulations will treat this transaction as a constructive sale of the position.

The Congress anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. One such transaction is a "collar." In a collar, a taxpayer commits to an option requiring him to sell a financial position at a fixed price (the "call strike price") and has the right to have his position purchased at a lower fixed price (the "put strike price"). For example, a shareholder may enter into a collar for a stock currently trading at $100

with a put strike price of $95 and a call strike price of $110. The effect of the transaction is that the seller has transferred the rights to all gain above the $110 call strike price and all loss below the $95 put strike price; the seller has retained all risk of loss and opportunity for gain in the price range between $95 and $110. A collar can be a single contract or can be effected by using a combination of put and call options.

In order to determine whether collars have substantially the same effect as the transactions specified in the provision, the Congress anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. It is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Congress intended that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

Another common transaction for which a specific regulatory standard may be appropriate is a so-called "in-the-money" option, i.e., a put option where the strike price is significantly above the current market price or a call option where the strike price is significantly below the current market price. For example, if a shareholder purchases a put option with a strike price of $120 with respect to stock currently trading at $100, the shareholder has eliminated all risk of loss on the position for the option period. The shareholder may also effectively have transferred substantially all of the potential gain on the stock because only if its value rises above $120 can there be any gain to the shareholder. In determining whether such a transaction will be treated as a constructive sale, the Congress anticipated that Treasury regulations will provide a specific standard that takes into account many of the factors described above with respect to collars, including the yield and volatility of the stock and the period and other terms of the option.

For collars, options and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models. The price of an option represents the payment the market requires to eliminate risk of loss (for a put option) and to purchase the right to receive yield and gain (for a call option). Thus, option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained.

In addition to setting specific standards for treatment of these and other transactions, it may be appropriate for Treasury regulations to establish "safe harbor" rules for common financial transactions that do not result in constructive sale treatment. An example might be a collar with a sufficient spread between the put and call prices, a sufficiently limited period and other relevant terms such that, regardless of the particular characteristics of the stock, the collar probably would not transfer substantially all risk of loss and opportunity for gain.

Effective Date

The provision is effective for constructive sales entered into after June 8, 1997. A special rule is provided for transactions before this date which would have been constructive sales under the provision. The positions in such a transaction will not be taken into account in determining whether a constructive sale after June 8, 1997, has occurred, provided that the taxpayer identified the offsetting positions of the earlier transaction before the close of the 30-day period beginning on the date of enactment (or a later date provided in Treasury regulations). The special rule will cease to apply on the date the taxpayer ceases to hold any of the offsetting positions so identified.

In the case of a decedent dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position (as defined in the provision) occurred before such date, (2) the transaction remains open (a) for not less than two years and (b) at some time during the three-year period ending on the decedent's death and (3) the transaction was not closed in a taxable transaction within 30 days after the date of enactment,[202] each of the appreciated financial position and the transaction resulting in the constructive sale will, if held at the time of the taxpayer's death, be treated as property constituting rights to receive income in respect of a decedent ("IRD") under section 691. However, where a constructive sale transaction that is subject to this rule is closed prior to death, gain that accrues after the transaction is closed will not be treated as IRD. The effect of these rules is generally to preserve the unrealized gain at the time the constructive sale transaction is entered into and to tax a net amount equal to such gain to the taxpayer and/or his heirs or legatees under the IRD rules (sec. 691).

For example, consider a "short against the box" transaction involving stock with a basis of $10 that was entered into when the stock was worth $100. Assume first that the taxpayer does not close the transaction and dies when the stock is worth $1,000, and assume for simplicity no changes in the stock value after the taxpayer's death. Under the IRD rules, the taxpayer's heirs will receive no step up in the stock's basis. When the heirs close the transaction by delivering the stock, they will recognize $990 of gain on the stock and a loss on the short position of $900, for a net recognized gain of $90, which is the same as the unrealized gain when the "short against the box" was entered into ($100 minus $10). As a second example, assume the taxpayer in the first example closed the "short against the box" (three years or less prior to his death) when the stock was worth $500 by delivering additional stock purchased in the market. The taxpayer would recognize a loss of $400 on the short position. If, at the time of taxpayer's death, he owns the stock that was the long position in the transaction, $490 of the gain on the stock would be treated as IRD. The taxpayer's heirs would receive no step up in basis for this amount and thus would recognize gain of $490 when they sell the stock. On a combined basis, the decedent and his heirs are taxed on gain of $90 ($490

[202] "A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(a)(4)) of H.R. 2676, of the Tax Technical Corrections Act of 1997, passed by the House on November 5, 1997.

minus $400), which is equal to the unrealized gain when the transaction was entered into.

Revenue Effect

Sections 1001 and 1002 of the Act are estimated on a combined basis to increase Federal fiscal year budget receipts by $367 million in 1998, $121 million in 1999, $68 million in 2000, $73 million in 2001, $79 million in 2002, $85 million in 2003, $94 million in 2004, $111 million in 2005, $118 million in 2006 and $127 million in 2007.

2. Election of mark to market for securities traders and for traders and dealers in commodities (sec. 1001(b) of the Act and secs. 475(e) and (f) of the Code)

Present and Prior Law

A dealer in securities must compute its income pursuant to a mark-to-market method of accounting (sec. 475). Any security that is inventory must be included in inventory at its fair market value, and any security that is not inventory and that is held at year end is treated as sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a "dealer in securities" is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; an interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of any security described above; and certain positions identified as hedges of any of the above. Any gain or loss taken into account under these provisions generally is treated as ordinary gain or loss.

Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers. Under prior law, the mark-to-market treatment applicable to securities dealers did not apply to traders in securities or to dealers in other property.

Reasons for Change

Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets. For market-valued assets, mark-to-market accounting imposes few burdens and offers few opportunities for manipulation. Securities and exchange-traded commodities have determinable market values, and securities traders and commodities traders and dealers regularly calculate year-end values of their assets in determining their income for financial statement purposes. Many commodities dealers also utilize year-end values in adjusting their in-

ventory using the lower-of-cost-or-market method for Federal income tax purposes.

Explanation of Provision

The Act allows securities traders and commodities traders and dealers to elect application of the mark-to-market accounting rules, which applied only to securities dealers under prior law. All securities held by an electing taxpayer in connection with a trade or business as a securities trader, and all commodities held by an electing taxpayer in connection with a trade or business as a commodities trader, are subject to mark-to-market treatment. The taxpayer is allowed to identify property not held in connection with its trade or business as not subject to the election. Gain or loss recognized by an electing taxpayer under the provision generally is ordinary gain or loss. The Congress intended that gain or loss that is treated as ordinary solely by reason of the election would not be treated as other than gain or loss from a capital asset for purposes of determining an individual's net earnings from self-employment under the Self-Employment Contributions Act (sec. 1402) or determining whether the passive-type income exception to the publicly-traded partnership rules is met (sec. 7704(c)).[203]

With respect to a commodities dealer, all of the rules of prior law section 475 apply as if commodities were securities. A commodity for purposes of the provision includes any commodity that is actively traded (within the meaning of section 1092(d)(1)), any option, forward contract, futures contract, short position, notional principal contract or derivative instrument that references such a commodity, and any other evidence of an interest in such a commodity. Also included are positions that hedge one of the items listed and that are identified by the taxpayer under rules similar to the rules for securities.

The Congress anticipated that Treasury regulations applying section 475(b)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment, will in the case of a commodities trader or dealer apply only to contracts and instruments referenced to commodities.

For a securities trader that elects application of the provision, all securities held in connection with its trade or business will be subject to mark-to-market accounting. An exception is provided for securities that have no connection with activities as a trader and that are identified on the day acquired (or at such other times as provided in Treasury regulations). The Congress did not intend that an electing taxpayer would be entitled to mark-to-market loans made to customers or receivables or debt instruments acquired from customers that are not received or acquired in connection with a trade or business as a securities trader. Any position that is properly subject to the mark-to-market regime will not be taken into account for purposes of the constructive sale rules of section 1259. Similar rules apply to commodities traders.

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[203] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(a)(3)) the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Because the Congress was concerned about issues of taxpayer selectivity, it was intended that an electing taxpayer must be able to demonstrate by clear and convincing evidence that a security bears no relation to activities as a trader in order to be identified as not subject to the mark-to-market regime. Any security that hedges another security that is held in connection with the taxpayer's trade or business as a trader will be treated as so held. The Congress also intended that the Secretary of the Treasury use his regulatory authority under section 475(g)(1) to prevent electing traders from effectively selecting the securities that are subject to mark-to-market treatment through use of related entities or other arrangements. Similar rules should apply to commodities traders.

The election is to be made separately with respect to the taxpayer's entire business as (1) a securities trader, (2) a commodities trader, or (3) a commodities dealer. Thus, a taxpayer that is both a commodities dealer and a securities trader may make the election with respect to one business, but not the other. The election will be made in the time and manner prescribed by the Secretary of the Treasury and will be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary.

Effective Date

The provision applies to taxable years of traders or dealers ending after the date of enactment (August 5, 1997). For a taxpayer making the election for a taxable year that includes the date of enactment, the taxpayer must have identified the securities or commodities to which the election applies within 30 days of the date of enactment. For elections for taxable years including the date of enactment, the adjustments required under section 481 as a result of the change in accounting method are required to be taken into account ratably over the four-year period beginning in the first taxable year for which the election is in effect.

Any elections made for taxable years beginning after the date of enactment will be governed by rules and procedures established by the Secretary of the Treasury.

Revenue Effect

The combined revenue effect of sections 1001 and 1002 of the Act is presented in the discussion of section 1001(a) of the Act above.

3. Limitation on exception for investment companies under section 351 (sec. 1002 of the Act and sec. 351(e) of the Code)

Present and Prior Law

A contribution of property to a corporation does not result in gain or loss to the contributing shareholder if the contributor is part of a group of contributors who have 80 percent control (as defined in sec. 368(c)). A contribution of property to a partnership generally does not result in recognition of gain or loss to the contributing partner.

Certain Code sections provide exceptions to the general rule for deferral of pre-contribution gain and loss. Gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company (sec. 351(e)(1)). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if the partnership were a corporation (sec. 721(b)). Under Treasury regulations, a contribution of property by a shareholder to a corporation, or by a partner to a partnership, is treated as a transfer to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interests, and (2) the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment (Treas. reg. sec. 1.351–1(c)(1)).

Reasons for Change

Under prior law and regulations, a partnership or a corporation was not treated as an investment company even though more than 80 percent of its assets were a combination of stock and securities and other high-quality investment assets of determinable values, such as non-convertible debt instruments, notional principal contracts, foreign currency and interests in metals. Thus, under prior law, a partner could contribute stock, securities or other assets to an investment partnership, and a shareholder could contribute such assets to a corporation (e.g., a RIC) and, without current taxation, receive an interest in an entity that was essentially a pool of high-quality investment assets. Where, as a result of such a transaction, the partner or shareholder diversified or otherwise changed the nature of the financial assets in which it had an interest, the transaction had the effect of a taxable exchange. Of particular concern to the Congress was the reappearance of so-called "swap funds," which are partnerships or RICs that are structured to fall outside the definition of an investment company, and thereby allow contributors to make tax-free contributions of stock and securities in exchange for an interest in an entity that holds similar assets.

Explanation of Provision

The Act modified the definition of an investment company for purposes of determining whether a transfer of property to a partnership or corporation results in gain recognition (secs. 351(e) and 721(b)) by requiring that certain assets be taken into account for purposes of the definition, in addition to readily marketable stock and securities as under prior law.

Under the Act, an investment company includes a RIC or REIT as under prior law. In addition, under the Act, an investment company includes any corporation or partnership if more than 80 percent of its assets by value consist of money, stocks and other equity interests in a corporation (whether or not readily marketable), evidences of indebtedness, options, forward or futures contracts, no-

tional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in REITs, RICs, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed. Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are assets listed above, and to the extent provided in Treasury regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.[204] Finally, the Act granted regulatory authority to the Treasury Department to add other assets to the list set out in the provision, or, under appropriate circumstances, to remove items from the list.

The Congress intended that the Act would change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. Reg. sec. 1.351–1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the Act did not override the requirement that only assets held for investment are considered for purposes of the definition (Treas. Reg. sec. 1.351–1(c)(1)(ii)). Thus, stock, securities or other listed assets held primarily for sale to customers in the ordinary course of business or used in a trade or business of banking, insurance, brokerage or a similar trade or business are not counted toward the 80-percent test (Treas. Reg. sec. 1.351–1(c)(3)). Similarly, the Act did not override the rule that, for purposes of determining whether a corporation or partnership is an investment company, the assets of a corporation are treated as owned proportionally by any shareholder (whether a corporation or other entity) owning 50 percent or more of its stock (Treas. Reg. sec. 1.351–1(c)(4)). The Act also did not override the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. Reg. sec. 1.351–1(c)(2)). For example, although under the Act, money is counted toward the 80-percent test, where money is contributed to a corporation or partnership and, pursuant to a plan, either (1) assets not counted toward the 80-percent test are purchased or contributed to the entity or (2) the entity makes expenditures not resulting in the acquisition of an asset (e.g. salaries), the investment company determination would be made on the basis of the entity's assets after such events. Finally, the Act did not override the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. Reg. sec. 1.351–1(c)(1)(i)).

Effective Date

The provision applies to all transfers after June 8, 1997, in taxable years ending after such date. An exception is provided for transfers of a fixed amount of securities made pursuant to a bind-

[204] Until such regulations are issued, it is intended that the Treasury regulations promulgated under the similar provisions of section 731(c)(2) generally will apply. Specifically, it is intended that an entity will meet the "substantially all" requirement if 90 percent or more of its assets are listed assets (Treas. Reg. sec. 1.731–2(c)(3)(i)). Similarly, with respect to partnerships and other non-corporate entities, it is intended that, where 20 percent or more (but less than 90 percent) of the entity's assets consist of listed assets, a *pro rata* portion of the interest in the entity will be treated as a listed asset (Treas. Reg. sec. 1.731–2(c)(3)(ii)).

ing written contract in effect on June 8, 1997, and at all times thereafter until the transfer.

Revenue Effect

The combined revenue effect of sections 1001 and 1002 of the Act is presented in the discussion of section 1001(a) of the Act above.

4. Gains and losses from certain terminations with respect to property (sec. 1003 of the Act and secs. 1233(h), 1234A, 1271(b) of the Code)

Present and Prior Law

Extinguishment treated as exchange

Treatment of gains and losses.—Gain from the "sale or other disposition" of property is the excess of the amount realized therefrom over its adjusted basis; loss is the excess of adjusted basis over the amount realized.

Definition of capital gain or loss.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset.[205] The U.S. Supreme Court has held that the term "sale or exchange" is a narrower term than "sale or other disposition."[206] Thus, it is possible for there to be taxable income from a sale or other disposition of an asset without that income being treated as a capital gain.

Court decisions interpreting the "sale or exchange" requirement.—There has been a considerable amount of litigation dealing with whether a modification of the legal relationship between taxpayers is treated as a "sale or exchange." For example, in *Douglass Fairbanks* v. *U.S.,* 306 U.S. 436 (1939), the U.S. Supreme Court held that gain realized on the redemption of bonds before their maturity is not entitled to capital gain treatment because the redemption was not a "sale or exchange".[207] Several court decisions interpreted the "sale or exchange" requirement to mean that a disposition that occurs as a result of a lapse, cancellation, or abandonment is not a sale or exchange of a capital asset, but produces ordinary income or loss. For example, in *Commissioner* v. *Pittston Co.,* 252 F. 2d 344 (2d Cir), *cert. denied*, 357 U.S. 919 (1958), a payment received by the taxpayer for terminating a long-term right to purchase the coal output from another company's mine was treated as ordinary income on the grounds that the payment was in lieu of subsequent profits that would have been taxed as ordinary income. Similarly, in *Commissioner* v. *Starr Brothers,* 205 F. 2d 673 (1953), the Second Circuit held that a payment received by a retail distributor

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[205] Code section 1221 defines a capital asset to mean property held by the taxpayer other than (1) property properly includible in inventory of the taxpayer or primarily held for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable and real property used in the taxpayer's trade or business, (3) a copyright, a literary musical, or artistic composition, letter or memorandum, or similar property that was created by the taxpayer (or whose basis is determined, in whole or in part, by reference to the basis of the creator), (4) accounts or notes receivable acquired in the ordinary course of the taxpayer's trade or business, and (5) a publication of the United States Government which was received from the Government other than by sale.

[206] *Helvering* v. *William Flaccus Oak Leather Co.,* 313 U.S. 247 (1941).

[207] The result in this case was overturned by enactment in 1934 of the predecessor of present law section 1271(a); see below. See section 117 of the Revenue Act of 1934, 28 Stat. 680, 714–715.

from a manufacturer in exchange for waiving a contract provision prohibiting the manufacturer from selling to the distributor's competition was not a sale or exchange. Likewise, in *General Artists Corp.* v. *Commissioner,* 205 F. 2d 360, *cert. denied* 346 U.S. 866 (1953), the Second Circuit held that amounts received by a booking agent for cancellation of a contract to be the exclusive agent of a singer were not from a sale or exchange. In *National-Standard Company* v. *Commissioner,* 749 F. 2d 369, the Sixth Circuit held that a loss incurred on the transfer of foreign currency to discharge the taxpayer's liability was an ordinary loss, since the transfer was not a "sale or exchange" of that currency. More recently, in *Stoller* v. *Commissioner,* 994 F. 2d 855 (1993), the Court of Appeals for the District of Columbia held, in a transaction that preceded the effective date of section 1234A, that losses incurred on the cancellation of forward contracts to buy and sell short-term Government securities that formed a straddle were ordinary because the cancellation of the contracts was not a "sale or exchange."

The U.S. Tax Court has held that the abandonment of property subject to non-recourse indebtedness is a "sale" and, therefore, any resulting loss is a capital loss. *Freeland* v. *Commissioner,* 74 T.C. 970 (1980); *Middleton* v. *Commissioner,* 77 T.C. 310 (1981), *aff'd per curiam* 693 F.2d 124 (11th Cir. 1982); and *Yarbro* v. *Commissioner,* 45 T.C.M. 170, aff'd. 737 F.2d 479 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985).

Extinguishment treated as sale or exchange.—The Internal Revenue Code contains provisions that deem certain transactions to be a sale or exchange and, therefore, any resulting gain or loss is to be treated as a capital gain or loss. These rules generally provide for "sale or exchange" treatment as a way of extending capital gain or loss treatment to those transactions.

Under one special provision, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). Personal property subject to this rule is (1) personal property of a type which is actively traded[208] and which is, or would be on acquisition, a capital asset in the hands of the taxpayer (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) and (2) a "section 1256 contract"[209] which is a capital asset in the hands of the taxpayer.[210] Section 1234A does not apply to the retirement of a debt instrument.

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[208] Treasury Regulations generally define "actively traded" as any personal property for which there is an established financial market. In addition, those regulations provide that a "notional principal contract constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market" and that "rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property." Treas. Reg. sec. 1.1092(d)–1(c).

[209] A "section 1256 contract" means any (1) regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

[210] The present-law provision (sec. 1234A) which treats cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property as a sale of a capital asset was added by Congress in 1981 when Congress adopted a number of provisions dealing with tax straddles. These are two components or "legs" to a straddle, where the value of one leg changes inversely with the value of the other leg. Without a special rule, taxpayers were able to "leg-out" of the loss leg of the straddle, while retaining the gain leg, resulting in the creation of an ordinary loss. In 1981, Congress believed that the effective ability of taxpayers to elect

Treatment of capital gains and losses.—Under prior law, long-term capital gains of individuals are subject to a maximum rate of tax of 28 percent. Capital losses of individuals are allowed to the extent of capital gains or the lower of those gains or $3,000.

Long-term capital gains of corporations are subject to the same rate of tax as ordinary income. Capital losses of corporations are allowed only to the extent of the corporation's capital gains; excess capital losses may be carried back to the 3 preceding years and carried forward for 5 succeeding years.

In the case of gains and losses from the sale or exchange of property used in a trade or business, net gains generally are treated as capital gain while net losses are treated as ordinary losses (sec. 1231).

Short positions that become substantially worthless

In the case of a "short sale" (i.e., where the taxpayer sells borrowed property (such as stock) and later closes the sale by repaying the lender with identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)), but the gain ordinarily is treated as short-term gain (sec. 1233(b)(1)). Entering into a contract to sell generally is treated as a short sale for purposes of these rules.

Character of gain on retirement of debt obligations

Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with original issue discount (OID)[211] generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity (sec. 1271(a)(2)). These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer. As a result of this exemption, the character of gain or loss realized on retirement of an obligation issued by a natural person under prior law was governed by case law.

Reasons for Change

Extinguishment treated as sale or exchange.—In general, the Congress believed that prior law was deficient since (1) it taxed similar economic transactions differently and (2) it effectively provided some, but not all, taxpayers with an election. Its lack of certainty made the tax laws unnecessarily difficult to administer.

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the character of a gain or loss leg of a straddle was unwarranted and provided the present law rule. However, since straddles were the focus of the 1981 legislation, that legislation was limited to types of property which were the subject of straddles, i.e., personal property (other than stock) of a type which is actively traded which is, or would be on acquisition, a capital asset in the hands of the taxpayer. The provision subsequently was extended to section 1256 contracts.

[211] The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligations even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income as it accrues as interest. The mandatory inclusion of OID in income does not apply, among other exceptions, to obligations issued by a natural person before March 2, 1984, and loans of less than $10,000 between natural persons if such loan is not made in the ordinary course of business of the lender (secs. 1272(a)(2)(D) and (E)).

The Congress believed that some transactions, such as settlements of contracts to deliver a capital asset, are economically equivalent to a sale or exchange of such contracts since the value of any asset is the present value of the future income that such asset will produce. In addition, to the extent that prior law treated modifications of property rights as not being a sale or exchange, prior law effectively provided taxpayers with an election to treat a transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that could offset higher-taxed ordinary income and not be subject to limitations on use of capital losses. The effect of an election could be achieved by selling the property right if the resulting transaction resulted in a gain or by providing for the extinguishment of the property right if the resulting transaction resulted in a loss.

Courts have given different answers as to whether transactions which terminate contractual interests are treated as a "sale or exchange." This lack of uniformity caused uncertainty to both taxpayers and the Internal Revenue Service in the administration of the tax laws.

Accordingly, the Act treats the cancellation, lapse, expiration, or other termination of a right or obligation with respect to any type of property which is (or on acquisition would be) a capital asset in the hands of the taxpayer as a "sale or exchange." A major effect of the Act would be to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions. Another significant effect of the Act would be to reduce the uncertainty concerning the tax treatment of modifications of property rights.

Short positions that become substantially worthless.—Congress also was concerned with the ability to postpone indefinitely gain on short positions where the underlying property becomes substantially worthless by simply not closing out the short position. The Congress believed that gain on the short position has been realized when the underlying property becomes substantially worthless and should be recognized at that time.

Character of gain on retirement of debt obligations issued by natural persons.—Similar objections can be raised about the prior law rule which exempts debt of natural persons from the deemed sale or exchange rule applicable to debt of other taxpayers. The Congress believed that the debt of natural persons and other taxpayers is sufficiently economically similar to be similarly taxed upon their retirement. Accordingly, the Congress believed that the exception to the deemed sale or exchange rule on retirement of debt of a natural person should be repealed.

Explanation of Provision

Extension of relinquishment rule to all types of property.—The Act extends to all types of property that is a capital asset in the hands of the taxpayer the rule of present law that treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property or section 1256 contracts which is (or on acquisition would be) a capital asset in the hands of the taxpayer, as gain or loss from the sale of a capital asset.

Thus, the extension of the "sale or exchange rule" of prior law section 1234A to all property that is a capital asset in the hands of the taxpayer affects capital assets that are (1) interests in real property and (2) non-actively traded personal property. An example of the first type of property interest that will be affected by the Act is the tax treatment of amounts received to release a lessee from a requirement that the premises be restored on termination of the lease.[212] An example of the second type of property interest that is affected by the Act is the forfeiture of a down payment under a contract to purchase stock.[213] The Act does not affect whether a right is property or whether property is a capital asset.

Short positions that become substantially worthless.—In addition, the Act provides that if a taxpayer enters into a short sale of property and such property becomes substantially worthless, the taxpayer shall recognize gain as if the short sale were closed when the property becomes substantially worthless. The Act also extends the statute of limitations with respect to such gain recognition to the earlier of: (1) three years after the Treasury Secretary is notified that the position has become substantially worthless; or (2) six years after the date of filing of the income tax return for the taxable year during which the position became substantially worthless. To the extent provided in Treasury regulations, similar gain recognition rules apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or with respect to any similar transaction or position that becomes substantially worthless.

Character of gain on retirement of debt obligations issued by natural persons.—The Act repeals the provision that exempts debt obligations issued by natural persons effective for obligations issued after June 8, 1997, from the rule which treats retirement as an exchange. In addition, the Act terminates the grandfather of debt issued before July 2, 1982, by noncorporations or nongovernments from the rule that treats gain or loss realized on retirement of such debt as gain or loss realized on an exchange, effective for obligations acquired by purchase (within the meaning of section 1272(d)(1)) after June 8, 1997. Thus, under the Act, gain or loss on the retirement of such debt will be capital gain or loss.

Effective Date

Extension of relinquishment rule to all types of property.—The extension of the extinguishment rule applies to terminations occurring more than 30 days after the date of enactment of the Act (August 5, 1997).

Short positions that become substantially worthless.—The provision applies to property that becomes substantially worthless after the date of enactment of the Act (August 5, 1997). No inference is

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[212] See *Billy Rose Diamond Horseshoe, Inc.* v. *Commissioner,* 448 F.2d 549 (1971), where the Second Circuit held that payments were not entitled to capital gain treatment because there was no sale or exchange. See also, *Sirbo Holdings, Inc.* v. *Commissioner,* 509 F.2d 1220 (2d Cir. 1975).

[213] See *U.S. Freight Co.* v. *U.S.,* 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

intended as to the proper treatment of these or similar transactions or positions under prior law.

Character of gain on retirement of debt obligations issued by natural persons.—The provision applies to sales, exchanges and retirements after date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $15 million in 1998, $27 million in 1999, and $25 million per year in each of the years 2000 through 2007.

5. Determination of original issue discount where pooled debt obligations subject to acceleration (sec. 1004 of the Act and sec. 1272 of the Code)

Present and Prior Law

Inclusion of interest income, in general

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer. If the principal amount of an indebtedness may be paid without interest by a specified date (as is the case with certain credit card balances), under present law, the holder of the indebtedness is not required to accrue interest until after the specified date has passed.

Original issue discount

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received until the maturity of the instrument.

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the time of maturity must be known. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a REMIC, (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument

may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

Reasons for Change

Interest income generally accrues over the period an amount is borrowed and repaid. Certain debt instruments, such as credit card receivables, do not require the debtors to pay interest if they pay their accounts by a specified date. The operation of the OID and interest accrual rules of prior law provided that, in such instances, the holder of the debt could assume that the debtors would remit their balances in a timely manner and thus avoid the interest charges. In the case of a large pool of such debt instruments, this prepayment assumption, as applied to all debtors in the pool, was unrealistic and may have resulted in the mismeasurement of income with respect to the interest charged to those debtors that did not prepay their account balances.

Explanation of Provision

The Act applies the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the payments on which may be affected by reason of prepayments. Thus, under the Act, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. In cases where the payments in the pool occur soon after year end and before the taxpayer files its tax return for the taxable year that includes such year end, the taxpayer may accrue interest based on its actual experience rather than based upon reasonable assumptions.

The Act operates as follows: Assume that a calendar year taxpayer issues credit cards, the terms of which provide that if the cardholder pays his or her balance in full within 25 days after the close of the monthly billing cycle, no interest will accrue with respect to such charges. However, if the balances are not paid within this 25-day grace period, interest will accrue from the date of the charge until the balance is paid. Further assume that the taxpayer issues a significant number of such credit cards and the cardholders incur charges of $10 million during the billing cycle that runs from December 16, 1998 to January 15, 1999. Under prior law (depending upon the taxpayer's accounting method), the taxpayer was not required to include any interest income in 1998 with respect to the billing cycle that includes December 31, 1998, because it is possible each credit cardholder will pay his or her balance in full before the end of the 25-day grace period (i.e., by February 10, 1998), and therefore no one will any incur any related finance charges. Under the Act, the taxpayer, in computing its 1998 taxable income, is required to make a reasonable assumption as to what portion of the $10 million cumulative balance attributable to

1998 will not be paid off within the 25-day grace period and is required to accrue interest income through December 31, 1998, with respect to such portion. The taxpayer would then adjust such accrual in 1999 to reflect the extent to which such prepayment assumption reflected the actual payments received during the grace period.

In addition, the Secretary of the Treasury is authorized to provide appropriate exemptions from the provision, including exemptions for taxpayers that hold a limited amount of debt instruments, such as small retailers.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (i.e., after August 5, 1997). If a taxpayer is required to change its method of accounting under the Act, such change is treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment is included in income ratably over a four-year period. It is understood that some taxpayers presently use a method of accounting similar to the method required to be used under the Act and have asked the Secretary of the Treasury for permission to change to a different method for pre-effective date years. It is within the discretion of the Secretary whether or not to grant these pending requests.[214]

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $76 million in 1998, $275 million in 1999, $358 million in 2000, $319 million in 2001, $283 million in 2002, $100 million in 2003, $105 million in 2004, $109 million in 2005, $114 million in 2006, and $118 million in 2007.

6. Deny interest deduction on certain debt instruments (sec. 1005 of the Act and sec. 163 of the Code)

Prior Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of

[214] See, IRS Notice 97–67, issued November 14, 1997, advising of upcoming guidance providing procedures for automatically changing methods of accounting with respect to grace period interest.

the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Reasons for Change

The Congress was concerned that corporate taxpayers may issue instruments denominated as debt but that more closely resemble equity transactions for which an interest deduction is not appropriate.

Explanation of Provision

Under the Act, no deduction is allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party. In addition, an instrument is to be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument also is treated as payable in stock if it is part of an arrangement that is reasonably expected to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. For example, it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt. The Act does not affect the treatment of a holder of an instrument.

For purposes of the provision, principal or interest shall be treated as required to be paid in, converted to, or determined with reference to the value of equity if it may be so required at the option of the holder or a related party and there is a substantial certainty that the option will be exercised.

The Act is not intended to affect the characterization of instruments as debt or equity under present or prior law; and no inference is intended as to the treatment of any instrument under prior law.

Effective Date

The provision is effective for instruments issued after June 8, 1997, but will not apply to such instruments (1) issued pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $5 million in 1998, $16 million in 1999, $29 million in 2000, $43 million in 2001, $55 million in 2002, $62 million in 2003, $63 million in 2004, $64 million in 2005, $65 million in 2006, and $67 million in 2007.

B. Corporate Organizations and Reorganizations

1. Require gain recognition for certain extraordinary dividends (sec. 1011 of the Act and sec. 1059 of the Code)

Prior Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)). The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock (sec. 1059(d)(1)(A)). The Treasury Department has general regulatory authority to carry out the purposes of the section.

Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns, where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented.[215] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[216]

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction

[215] See H. Rept. 99–841, II–166, 99th Cong. 2d Sess. (September 18, 1986).
[216] See Treas. Reg. sec. 1.701–2(f), Example (2).

computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference (sec. 356(a)(2)).

Reasons for Change

Corporate taxpayers have attempted to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transactions are dividends that qualify for the dividends received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some cases, it appears that the taxpayers' interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced, and are, therefore, dividends.[217] Some taxpayers may argue that certain options have sufficient economic reality that they should be recognized as stock ownership for purposes of determining whether a taxpayer has substantially reduced its ownership.

Even in the absence of options, the present law rules dealing with extraordinary dividends may permit inappropriate deferral of gain recognition when the portion of the distribution that is excluded due to the dividends received deduction exceeds the basis of the stock with respect to which the extraordinary dividend is received.

Explanation of Provision

Under the Act, except as provided in regulations, a corporate shareholder recognizes gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.[218]

In addition, the Act requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock is treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction re-

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[217] For example, it has been reported that Seagram Corporation intends to take the position that the corporate dividends-received deduction will eliminate tax on significant distributions received from DuPont Corporation in a redemption of almost all the DuPont stock held by Seagram, coupled with the issuance of certain rights to reacquire DuPont stock. See e.g., Landro and Shapiro, "Hollywood Shuffle," *Wall Street Journal,* pp. A1 and A11 (April 7, 1995); Sloan, "For Seagram and DuPont, a Tax Deal that No One Wants to Brandy About," *Washington Post,* p. D3 (April 11, 1995); Sheppard, "Can Seagram Bail Out of DuPont without Capital Gain Tax," *Tax Notes Today,* (April 10, 1995, 95 TNT 75–4).

[218] Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a dividend.

lates.[219] Except as provided in regulations, it is not expected that the provision will cause current gain recognition in consolidated return situations to the extent that the consolidated return regulations require the creation or increase of an excess loss account.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under continuing section 1059(g) of present law, the Treasury Department is authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the provision.

Effective Date

The provision generally is effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995, and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995.[220] However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under prior law of any transaction within the scope of the provision, including transactions utilizing options.

In addition, no inference is intended regarding the rules under prior law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $44 million in 1998, to decrease Federal fiscal year budget receipts by $93 million in 1999, $54 million in 2000, and $10 million in 2001, and to increase Federal fiscal year budget receipts by $45 million in 2002, $77 million in 2003, $81 million in 2004, $89 million in 2005, $95 million in 2006, and $101 million in 2007.

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[219] For redemptions, the reduction in basis of stock is treated as occurring at the beginning of the date holders of the stock become entitled to receive the redemption proceeds.

[220] Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present-law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

2. Require gain recognition on certain distributions of controlled corporation stock (sec. 1012 of the Act and secs. 355, 358, 351(c), and 368(a)(2)(H) of the Code)

Prior Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain "spin-off" type distributions of stock of a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution.

In cases where the form of the transaction involves a contribution of assets to the particular controlled corporation that is distributed in connection with the distribution, there are specific Code requirements that distributing corporation's shareholders own "control" of the distributed corporation immediately after the distribution. Control is defined for this purpose as 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class of stock (secs. 368(a)(1)(D), 368(c), and 351(a) and (c)). In addition, it is a requirement for qualification of any section 355 distribution that the distributing corporation distribute control of the controlled corporation (defined by reference to the same 80-percent test).[221] Present law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company acquired is the controlled corporation rather than the distributing corporation.

After a spin-off transaction, the amount of a stockholder's basis in the stock of the distributing corporation is generally allocated between the stock of distributing and controlled received by that shareholder, in proportion to their relative fair market values (sec. 358(c); see Treas. reg. sec. 1.358–2). In the case of an affiliated group of corporations filing a consolidated return, this basis allocation rule generally eliminates any excess loss account in the stock of a controlled corporation that is distributed within the group, and its basis is generally determined with reference to the basis of the distributing corporation.[222]

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[221] If a controlled corporation is acquired after a distribution, an issue may arise whether the acquisition can be viewed under step-transaction concepts as having occurred before the distribution, with the result that the distributing corporation would not be viewed as having distributed the necessary 80 percent control. The Internal Revenue Service had indicated that it would not rule on requests for section 355 treatment in cases in which there have been negotiations, agreements, or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not "controlled" by the distributing corporation. Rev. Proc. 96–39, 1996–33 I.R.B. 11, as incorporated in Rev. Proc. 97–3, 1997–1 I.R.B. 85 at sec. 5.17, modified by Rev. Proc. 97–53, 1997–47 I.R.B. 10 to delete sec. 5.17; see also Rev. Rul. 96–30, 1996–1 C.B. 36; Rev. Rul. 70–225, 1970–1 C.B. 80.

[222] Excess loss accounts in consolidation generally are created when a subsidiary corporation makes a distribution (or has a loss that is used by other members of the group) that exceeds the parent's basis in the stock of the subsidiary. In general, such excess loss accounts in consolidation are permitted to be deferred rather than causing immediate taxable gain. Nevertheless,

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The treatment of basis of the distributing and controlled corporations in a section 355 distribution differs from a distribution of stock that is not a qualified section 355 spin-off. In a non-qualified distribution within an affiliated group of corporations filing a consolidated return, not only is gain generally recognized (though deferred) on the excess of value over basis at the distributing corporation level, the basis of the distributing corporation's stock is increased by any gain recognized in the distribution (when that gain is taken into account under the relevant regulations), and reduced by the fair market value of the distribution if the distribution is within an affiliated group filing a consolidated return. The basis of the stock of the distributed corporation within the group is a fair market value basis. In the case of a nonqualified distribution between members of an affiliated group that is not filing a consolidated return, the distribution causes a reduction of basis of the distributing corporation only to the extent it exceeds the earnings and profits of the distributing corporation or it is an extraordinary dividend.

Reasons for Change

The Congress believed that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.

The Congress also believed that the difference in treatment of certain transactions following a spin-off, depending upon whether the distributing or controlled corporation engages in the transaction, should be minimized.

The Congress also was concerned that spin-off transactions within a single corporate group can have the effect of avoiding other present law rules that create or recapture excess loss accounts in affiliated groups filing consolidated returns. Some intra-group distributions may have the effect of permitting inappropriate basis increases (or preventing basis decreases) following a distribution, due to the differences between the basis allocation rules that govern spin-offs and those that apply to other distributions. In the case of an affiliated group not filing a consolidated return, it is also possible that section 355 distributions could in effect permit similar inappropriate basis results.

Explanation of Provision

The Act adopts additional restrictions under section 355 on acquisitions and dispositions of the stock of the distributing or controlled corporation.

Under the Act, if either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the

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they are recaptured when a subsidiary leaves the group or in certain other situations. However, such excess loss accounts are not recaptured in certain cases where there is an internal spin-off prior to the subsidiary leaving the group. See, Treas. Reg. sec. 1.1502–19(g). In addition, an excess loss account may not be created at all in certain cases that are similar economically to a distribution that would reduce the stock basis of the distributing subsidiary corporation, if the distribution from the subsidiary is structured to meet the form of a section 355 distribution.

date of distribution, gain is recognized as of the date of the distribution.

In the case of an acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. Such gain is recognized immediately before the distribution and is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.[223]

Whether a corporation is acquired is determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire 50 percent or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly owned subsidiary ("S") to its shareholders in a transaction that otherwise qualifies as a section 355 spin-off. If, pursuant to a plan or arrangement, 50 percent or more of the vote or value of either P or S is acquired by one or more persons, the Act requires gain recognition by the distributing corporation. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under section 368(a)(1)(A), (C) or (D) of the Code, the shareholders (immediately before the acquisition) of the corporation acquiring such assets are treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule.

Under the Act, certain aggregation and attribution rules apply for determining whether one or more persons has acquired a 50-percent or greater interest in distributing or controlled. The aggregation rules of section 355(d)(7)(A) apply. In addition, except as provided in regulations, section 318(a)(2)(C) applies without regard to the amount of stock ownership of the corporation.

A public offering of sufficient size can result in an acquisition that causes gain recognition under the provision.

Acquisitions occurring within the four-year period beginning two years before the date of distribution are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the Act, including regulations to provide for the application of the changes made by the Act in the case of multiple transactions.

Certain transactions not considered acquisitions

Under the Act, certain specific types of transactions do not cause gain recognition or are not counted as acquisitions for purposes of

[223] There is no intention to limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code. There is also no intention to limit the otherwise applicable provisions of section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

determining whether there has been an acquisition of a 50-percent or greater interest in the distributing or the controlled corporation.

Single affiliated group

Under the Act, a plan (or series of related transactions) is not one that will cause gain recognition if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group of corporations (as defined in section 1504 without regard to subsection (b) thereof).

Example 1: P corporation is a member of an affiliated group of corporations that includes subsidiary corporation S and subsidiary corporation S1. P owns all the stock of S. S owns all the stock of S1. P corporation is merged into unrelated X corporation in a transaction in which the former shareholders of X corporation will own 50 percent or more of the vote or value of the stock of surviving X corporation after the merger. As part of the plan of merger, S1 will be distributed by S to X, in a transaction that otherwise qualifies under section 355. After this distribution, S, S1, and X will remain members of a single affiliated group of corporations under section 1504 (without regard to whether any of the corporations is a foreign corporation, an insurance company, a tax exempt organization, or an electing section 936 company). Even though there has been an acquisition of P, S, and S1 by X, and a distribution of S1 by S that is part of a plan or series of related transactions, the plan is not treated as one that requires gain recognition on the distribution of S1 to X. This is because the distributing corporation S and the controlled corporation S1 remain within a single affiliated group after the distribution (even though the P group has changed ownership).

Continuing direct or indirect ownership

Under the Act, except as provided in Treasury regulations, certain acquisitions are not taken into account in determining whether a 50-percent or greater interest in distributing or controlled has been acquired. Generally, in any transaction, stock received directly or indirectly by former shareholders of distributing or controlled, in a successor or new controlling corporation of either, is not treated as acquired stock if it is attributable to such shareholders' stock in distributing or controlled that was not acquired as part of a plan or arrangement to acquire 50 percent or more of such successor or other corporation.

Section 355(e)(3)(A)(iv) of the Act, as originally enacted, provided that an acquisition does not require gain recognition if the same persons own 50 percent or more of both corporations, directly or indirectly (rather than merely indirectly, as in the House bill and Senate amendment), before and after the acquisition and distribution, provided the stock owned before the acquisition was not acquired as part of a plan (or series of related transactions) to acquire a 50-percent or greater interest in either distributing or controlled. The intention of Congress, however, was that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in such corporation by each person

owning stock in such corporation immediately before the acquisition does not decrease.[224]

Example 2: Individual A owns all the stock of P corporation. P owns all the stock of a subsidiary corporation, S. Subsidiary S is distributed to individual A in a transaction that otherwise qualifies under section 355. As part of a plan, P then merges with corporation X, also owned entirely by individual A. There is not an acquisition that requires gain recognition under the provision, because individual A owns directly or indirectly 100 percent of all the stock of both X, the successor to P, and S before and after the transaction.[225] The same result would occur if P were contributed to a holding company, all the stock of which is owned by A.

Example 3: Assume the facts are the same as in Example 2 except that corporations P and X are each owned by the same 20 individual 5-percent shareholders (rather than wholly by individual A). The transaction described in Example 2, in which S is spun off by P to P's shareholders and P is acquired by X, would not cause gain recognition, because each shareholder that owned stock of distributing and controlled before the transaction continues to own the same percentage of stock of each corporation after the transaction.

Example 4: Shareholder A owns 10 percent of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100 percent of the vote and value of the stock of unrelated corporation P. D distributes C pro rata to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder's respective 10 percent former stock ownership in D. Each of the former shareholders of D owns 1 percent of the stock of the merged corporation, except that shareholder A (who owned 100 percent of corporation P and 10 percent of corporation D before the merger) now owns 91 percent of the stock of the merged corporation. In determining whether a 50-percent or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder's direct or indirect ownership. Thus, the 10-percent interest of A, and the 1-percent interest of each of the nine other former shareholders of D, is not counted. The remaining 81-percent ownership of the merged corporation, representing a decrease of nine percent in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50-percent or greater interest in D has been acquired.[226]

Except as provided in Treasury regulations, certain other acquisitions also are not taken into account. For example, under section

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[224] A technical correction may be needed so that the statute reflects this result. See Title VI (sec. 609(b)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

[225] The example assumes that A did not acquire his or her stock in P as part of a plan or series of related transactions that results in the direct or indirect ownership of 50 percent or more of S or P separately by A. If A's stock in P was acquired as part of such a plan, the transaction would be one requiring gain recognition on the spin-off of S.

[226] This example reflects the technical correction contained in Title VI (sec. 609(b)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

355(e)(3)(A), the following other types of acquisitions of stock are not subject to the provision, provided that the stock owned before the acquisition was not acquired pursuant to a plan or series of related transactions to acquire a 50-percent or greater ownership interest in either distributing or controlled:

First, the acquisition of stock in the controlled corporation by the distributing corporation (as one example, in the case of a contribution of property by the distributing corporation to the controlled corporation in exchange for the stock of the controlled corporation);

Second, the acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (as one example, the receipt by a distributing corporation shareholder of controlled corporation stock in a distribution—including a split-off distribution in which a shareholder that did not own 50 percent of the stock of distributing owns 50 percent or more of the stock of controlled); and

Third, the acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation (for example, the receipt by former shareholders of distributing of 50 percent or more of the stock of a successor corporation in a merger of distributing).

The Act does not apply to distributions that would otherwise be subject to section 355(d) of present law, which imposes corporate level tax on certain disqualified distributions.

The Act does not apply to a distribution pursuant to a title 11 or similar case.

Section 355(f)

The Act provides that, except as provided in Treasury regulations, section 355 (or so much of section 356 as relates to section 355) shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in section 1504(a)) to another member of such group (an "intragroup spin-off") if such distribution is part of a plan (or series of related transactions) described in subsection (e)(2)(A)(ii), pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

Example 5: P corporation owns all the stock of subsidiary corporation S. S owns all the stock of subsidiary corporation T. S distributes the stock of T corporation to P as part of a plan or series of related transactions in which P then distributes S to its shareholders and then P is merged into unrelated X corporation. After the merger, former shareholders of X corporation own 50 percent or more of the voting power or value of the stock of the merged corporation. Because the distribution of T by S is part of a plan or series of related transactions in which S is distributed by P outside the P affiliated group and P is then acquired under section 355(e), section 355 in its entirety does not apply to the intragroup spin-off of T to P, under section 355(f). Also, the distribution of S by P is subject to section 355(e).

In determining whether an acquisition described in subsection (e)(2)(A)(ii) occurs, all the provisions of new subsection 355(e) are

applied. For example, an intragroup spin-off in connection with an overall transaction that does not cause gain recognition under section 355(e) because it is described in section 355(e)(2)(C), or because of section 355(e)(3), or because of the effective date of section 355(e), is not subject to the rule of section 355(f).

The Treasury Department has regulatory authority to vary the result that the intragroup distribution under section 355(f) does not qualify for section 355 treatment. In this connection, the Treasury Department could by regulation eliminate some or all of the gain recognition required under section 355(f) in connection with the issuance of regulations that would cause appropriate basis results with respect to the stock of S and T in the above example so that concerns regarding present law section 355 basis rules (described below in connection with section 358(c)) would be eliminated.[227]

Treasury regulatory authority under section 358(g)

The Act provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under section 355 ("intragroup spin-off"), the Secretary of the Treasury is authorized under section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution. It is understood that the approach of any such regulations applied to intragroup spin-offs that do not involve an acquisition may also be applied under the Treasury regulatory authority to modify the rule of section 355(f) as may be appropriate.

Congress believed that the concerns relating to basis adjustments in the case of intragroup spin offs are essentially similar, whether or not an acquisition is currently intended as part of a plan or series of related transactions. The concerns include the following. First, under present law consolidated return regulations, it is possible that an excess loss account of a lower tier subsidiary may be eliminated. This creates the potential for the subsidiary to leave the group without recapture of the excess loss account, even though the group has benefitted from the losses or distributions in excess of basis that led to the existence of the excess loss account.

Second, under present law, a shareholder's stock basis in its stock of the distributing corporation is allocated after a spin-off between the stock of the distributing and controlled corporations, in proportion to the relative fair market values of the stock of those companies. If a disproportionate amount of asset basis (as compared to value) is in one of the companies (including but not limited to a shift of value and basis through a borrowing by one company and contribution of the borrowed cash to the other), present law rules under section 358(c) can produce an increase in stock basis relative to asset basis in one corporation, and a corresponding decrease in stock basis relative to asset basis in the other company. Because the spin-off has occurred within the corporate group, the group can continue to benefit from high inside asset basis either for purposes of sale or depreciation, while also choosing to benefit from the disproportionately high stock basis in the other corporation. If,

[227] Examples of approaches that the Treasury Department may consider are discussed in connection with section 358(g), *infra*.

for example, both corporations were sold at a later date, a prior distribution can result in a significant decrease in the amount of gain recognized than would have occurred if the two corporations had been sold together without a prior spin off (or separately, without a prior spin-off).

Example 6: P owns all the stock of S1 and S1 owns all the stock of S2. P's basis in the stock of S1 is 50; the inside asset basis of S1's assets is 50; and the total value of S1's stock and assets (including the value of S2) is 150. S1's basis in the stock of S2 is 0; the inside basis of S2's assets is 0; and the value of S2's stock and assets is 100. If S1 were sold, holding S2, the total gain would be 100. S1 distributes S2 to P in a section 355 transaction. After this spin-off, under present law, P's basis in the stock of S1 is approximately 17 (50/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S1 is 50. P's basis in the stock of S2 is 33 (100/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S2 is 0. After a period of time, S2 can be sold for its value of 100, with a gain of 67 rather than 100. Also, since S1 remains in the corporate group, the full 50 inside asset basis can continue to be used. S1's assets could be sold for 50 with no gain or loss. Thus, S1 and S2 can be sold later at a total gain of 67, rather than the total gain of 100 that would have occurred had they been sold without the spin-off.

As one variation on the foregoing concern, taxpayers have attempted to utilize spin-offs to extract significant amounts of asset value and basis, (including but not limited to transactions in which one corporation decreases its value by incurring debt, and increases the asset basis and value of the other corporation by contributing the proceeds of the debt to the other corporation) without creation of an excess loss account or triggering of gain, even when the extraction is in excess of the basis in the distributing corporation's stock.

The Treasury Department may promulgate any regulations necessary to address these concerns and other collateral issues. As one example, the Treasury Department may consider providing rules that require a carryover basis within the group (or stock basis conforming to asset basis as appropriate) for the distributed corporation (including a carryover of an excess loss account, if any, in a consolidated return). Similarly, the Treasury Department may provide a reduction in the basis of the stock of the distributing corporation to reflect the change in the value and basis of the distributing corporation's assets. The Treasury Department may determine that the aggregate stock basis of distributing and controlled after the distribution may be adjusted to an amount that is less than the aggregate basis of the stock of the distributing corporation before the distribution, to prevent inappropriate potential for artificial losses or diminishment of gain on disposition of any of the corporations involved in the spin-off. The Treasury Department may provide separate regulations for corporations in affiliated groups filing a consolidated return and for affiliated groups not filing a consolidated return, as appropriate to each situation.

Control requirement for certain transactions

The Act also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to certain reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50 percent interest in the vote and value of stock of the distributed corporation.

The Act does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the Act regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but generally would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Effective Date

The provision is generally effective for distributions after April 16, 1997. However, the part of the provision providing a greater-than-50-percent control requirement immediately after certain section 351 and 368(a)(1)(D) distributions is effective for transfers after August 5, 1997.

The provision does not apply to a distribution after April 16, 1997 that is part of an acquisition that would otherwise cause gain recognition to the distributing or controlled corporation under new section 355(e) or (f), if such acquisition is (1) made pursuant to a written agreement which was binding on April 16, 1997 and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission ("SEC") required solely by reason of the distribution or acquisition. Any written agreement, ruling request, or public announcement or SEC filing is not within the scope of these transition provisions unless it identifies the acquiror of the distributing corporation or of any controlled corporation, whichever is applicable.

The part of the provision providing a greater-than-50-percent control provision for certain transfers after the date of enactment will not apply if such transfer meets the requirements of (1), (2), or (3) of the preceding paragraph.

An acquisition of stock that occurs on or before April 16, 1997, will not cause gain recognition under the provision, even if there is a distribution after that date that is part of a plan or series of related transactions that would otherwise be subject to the provision.

Any contract that is, in fact, binding under State law as of April 16, 1997, even though not written, is eligible for transition relief. It would be expected, in such a case, that some form of contemporaneous written evidence of such contract would be in existence. As one example, if under State law acceptance of the terms and conditions of a contract by a corporate board of directors creates a binding contract with an acquiror, then such contract, and the terms and conditions presented to the board, could satisfy the requirement for binding contract transitional relief under the conference agreement. If there was such an offer and acceptance on or before April 16, 1997, and a ruling request filed on or before April 16, 1997, with respect to a proposed spin-off and acquisition, which identifies the acquiror as one of a list of prospective acquirors, then the transaction may be eligible for relief under the transition rules.

Finally, with respect to the Treasury Department regulatory authority under section 358(g) as applied to intragroup spin-off transactions that are not part of a plan or series of related transactions under new section 355(f), the provision applies to distributions after April 16, 1997.[228] However, Congress expects that any Treasury regulations will be applied prospectively, except in cases to prevent abuse.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $301 million in 1998, $243 million in 1999, $216 million in 2000, $187 million in 2001, $158 million in 2002, $130 million in 2003, $101 million in 2004, $73 million in 2005, $46 million in 2006, and $10 million in 2007.

3. Reform tax treatment of certain corporate stock transfers (sec. 1013 of the Act and secs. 304 and 1059 of the Code)

Prior Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902. Section 304 does not apply to transfers of stock between members of a consolidated group.

[228] A technical correction may be needed so that the statute reflects this result. See Title VI (sec. 609(b)(1)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the dividends received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the nontaxed portion of such dividend.

Reasons for Change

Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution. These concerns are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the availability of the dividends received deduction. A corporation often may prefer a transaction to be characterized as a dividend, as opposed to a sale or exchange. Accordingly, a corporation may intentionally seek to apply section 304 to a transaction which is in substance a sale or exchange. Corporations that are related for purposes of section 304 need not be 80-percent controlled by a common parent. The separate rules for corporations filing a consolidated return, that would generally reduce basis for untaxed dividends received, do not apply. Furthermore, in some situations where the selling corporation does not in fact own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.

As one example, in certain related-party sales the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly in any shares of the acquiring corporation that it may own) need not be reduced by the amount of its dividends received deduction. This could result in an inappropriate shifting of basis. The result can be artificial reduction of gain or creation of loss on disposition of any such retained shares.

For example, assume that domestic corporation X owns 70 percent of the shares of domestic corporation S and all the shares of domestic corporation B. S owns all the shares of domestic corporation T with a basis of $100. Assume that corporation B has sufficient earnings and profits so that any distribution of property would be treated as a dividend. Assume that S sells all but one of its shares in T to B for $99, their fair market value. The transfer is treated as a redemption of shares of B, which redemption is treated as a dividend to S because, even though S in fact owns no shares of B, it is deemed to own all the shares of B before and after the transaction through attribution from X. In such a case, taxpayers may have contended that the one share of T retained (worth $1) retains the entire original basis of $100. Although S has received $99 from B for its other shares of T, and has not paid full tax on that receipt due to the dividends received deduction, S may now attempt to claim a $99 loss on disposing of the remaining share of T.

In international cases, a U.S. corporation owned by a foreign corporation may inappropriately claim foreign tax credits from a section 304 transaction. For example, if a foreign-controlled domestic corporation sells the stock of a subsidiary to a foreign sister cor-

poration, the domestic corporation may have taken the position that it is entitled to credit foreign taxes that were paid by the foreign sister corporation. See Rev. Rul. 92–86, 1992–2 C.B. 199; Rev. Rul. 91–5, 1991–1 C.B. 114. However, if the foreign sister corporation had actually distributed its earnings and profits to the common foreign parent, no foreign tax credits would have been available to the domestic corporation.

Explanation of Provision

Under the Act, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies,[229] and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the Act amends section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

Under the Act, a special rule applies to section 304 transactions involving acquisitions by foreign corporations. The Act limits the earnings and profits of the acquiring foreign corporation that are taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account will not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of sec, 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) would apply. The Secretary of the Treasury is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

No inference is intended as to the treatment of any transaction under prior law.

Effective Date

The provision is effective for distributions or acquisitions after June 8, 1997, except that the provision will not apply to any such distribution or acquisition (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue

[229] In determining the holding period of stock deemed to have been contributed and redeemed under the provision, the tacking of holding period rules applicable under section 351 apply for purposes of the provision.

Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $10 million in 1998, $10 million in 1999, and $5 million in each of the years 2000 through 2007.

4. Treat certain preferred stock as "boot" (sec. 1014 of the Act and secs. 351, 354, 355, 356, and 1036 of the Code)

Prior Law

In reorganization transactions within the meaning of section 368 and certain other restructurings, no gain or loss is recognized except to the extent "other property" (often called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock would be received tax-free in a reorganization. Upon the receipt of "other property," gain (or, in some situations, loss) is recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this securities-for-securities rule, similar rules generally apply to transactions under section 351.

Reasons for Change

Certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments.

As one example, a shareholder of a corporation that is to be acquired for cash may not wish to recognize gain on a sale of his or her stock at that time. Transactions are structured so that a new holding company is formed, to which the shareholder contributes common stock of the company to be acquired, and receives in exchange preferred stock. The acquiring corporation contributes cash to a holding company, which uses the cash to acquire the stock of the other shareholders. Similar results might also be obtained if the corporation to be acquired recapitalized by issuing the preferred stock in exchange for the common stock of the shareholder. Features such as puts and calls may effectively determine the period within which total payment is to occur. In the case of an individual shareholder, the preferred stock may be puttable or redeemable only at death, in which case the shareholder would obtain a basis step-up and never recognize gain on the transaction.

Similarly, as another type of example, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on preferred stock so that it tracks changes in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of stock would change if interest rates changed.

The Congress believed that when such preferred stock instruments are received in certain exchange transactions, it is appro-

priate to view such instruments as taxable consideration since the investor has often obtained a more secure form of investment.

Explanation of Provision

The Act amends the relevant provisions (secs. 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351, 355, 368, or 1036, gain (or in some instances loss) is recognized.

For purposes of section 351, nonqualified preferred stock is treated as "boot" under section 351(b). The transferor receiving such stock thus is not treated as receiving nonrecognition treatment under section 351(a). However, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise.

Section 351(b) applies to a transferor who transfers property in a section 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor of loss property received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as a section 351 exchange, such a transferor would recognize loss under section 1001 of the Code and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular taxpayer had received solely "other property" of any other type.[230] However, as with any other loss, this loss could be disallowed by the application of section 267 or by the application of any other provision that would disallow or defer the recognition of a loss.

For example, if A contributes appreciated property to new corporation X for all the common stock (representing 90 percent of the value and all the voting power) of X stock and B contributes appreciated property for nonqualified preferred stock representing 10 percent of the value of X stock, B has received "boot," but the preferred stock is still treated as stock for purposes of sections 351(a) and 368(c), unless and until Treasury Regulations are issued requiring a different result. Thus, the transaction as a whole (apart from B's treatment with respect to nonqualified preferred stock) qualifies for non-recognition under section 351 and A does not recognize gain. If B had received other stock in addition to nonqualified preferred stock, B would be required to recognize gain only to the extent of the fair market value of the nonqualified preferred stock B receives.

The Act applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of secs. 267(b) and 707(b)) to redeem or purchase the stock, (2) the

[230] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(c)(1)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). Factors (1), (2) or (3) above will cause an instrument to be nonqualified preferred stock only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder, but only if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is readily tradable on an established securities market or otherwise.[231] For this purpose, stock of a corporation is treated as stock that is readily tradable on an established securities market or otherwise if such exchange is part of a transaction or series of transactions in which such corporation is to become a corporation that has, or a related corporation of which has, readily tradable stock. Also, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

In no event will a conversion privilege into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent. Stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent for purposes of the provision.

The following exchanges are excluded from gain recognition under the provisions of sections 354, 355 and 356: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations.

Exclusions (1), (2) and (3) result from the fact that nonqualified preferred stock is treated as "other property" under sections 354,

[231] Conversely, in a case involving a corporation that has (or any related corporation of which has) any class of readily tradable stock, or that is to become such a corporation, suppose a shareholder (A) exchanges appreciated common stock of corporation X for preferred stock of corporation Y in a transaction otherwise qualifying as a section 351 exchange. The preferred stock is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, and is redeemable at the end of 21 years from the date of issuance or upon the death of A. At the time of the exchange, A is 80 years old (or is in ill health). If, under actuarial tables or under the facts and circumstances of A's case the contingency of A's death (which is certain to occur) is likely to occur within 20 years of the date of the exchange, then the preferred stock is nonqualified preferred stock if corporation X or Y (or any related corporation of corporation X or Y) has any class of stock that is readily tradable, or if X or Y (or any related corporation of X or Y) is to become such a corporation.

355 and 356 only if received in exchange for stock (or, under section 355, with respect to stock) that is not nonqualified preferred stock. Thus, if nonqualified preferred stock is received for or with respect to other nonqualified preferred stock, or for debt securities, gain recognition is not required. The receipt of nonqualified preferred stock for comparable nonqualified preferred stock of the same or lesser value, or the exchange of debt securities for nonqualified preferred stock of the same or lesser value, are considered to be exchanges "for" or "with respect to" such stock that are permitted. Similarly, the exchange of nonqualified preferred stock for common stock would not be within the scope of the provision because in such a transaction, nonqualified preferred stock is not received in the exchange.

For purposes of the exception for exchanges in certain recapitalizations of family owned corporations, a family-owned corporation is defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in section 447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member are treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences continue to apply.

The statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.[232]

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of the provision. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary has regulatory authority under the provision, including, for example, authority to (1) apply installment sale-type rules to preferred stock that is subject to the provision in

[232] A technical correction may be needed so that the statute reflects this intent. See Title VI (sec. 609(c)(2)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

Effective Date

The provision is effective for transactions after June 8, 1997, but will not apply to such transactions (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $35 million in 1998, $37 million in 1999, $39 million in 2000, $41 million in 2001, $43 million in 2002, $10 million in 2003, $10 million in 2004, $11 million in 2005, $11 million in 2006, and $12 million in 2007.

5. Modify holding period for dividends-received deduction (sec. 1015 of the Act and sec. 246(c) of the Code)

Prior Law

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Reasons for Change

The Congress was concerned that dividend-paying stocks can be marketed to corporate investors with accompanying attempts to hedge or relieve the holder from risk for much of the holding period of the stock, after the initial holding period has been satisfied. In addition, because of the limited application of section 1059 of the Code requiring basis reduction, many investors whose basis includes a price paid with the expectation of a dividend may be able to sell the stock after the receipt of a dividend not subject to tax

at an artificial loss, even though the holder may actually have been relieved of the risk of loss for much of the period it has held the stock.

The Congress believed that no deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest at a time proximate to the time the distribution is made.

Explanation of Provision

The Act provides that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The Act is generally effective for dividends paid or accrued after the 30th day after the date of enactment. However, the provision does not apply to dividends received within two years of the date of enactment if: (1) the dividend is paid with respect to stock held on June 8, 1997, and all times thereafter until the dividend is received; (2) the stock is continuously subject to a position described in section 246(c)(4) on June 8, 1997, and all times thereafter until the dividend is received; and (3) such stock and related position is identified by the taxpayer within 30 days after enactment of this Act (i.e., before September 5, 1997). A stock will not be considered to be continuously subject to a position if such position is sold, closed or otherwise terminated and is reestablished.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $11 million in 1998, $13 million in 1999, $15 million in 2000, $16 million in 2001, $16 million in 2002, $16 million in 2003, $17 million in 2004, $17 million in 2005, $17 million in 2006, and $18 million in 2007.

C. Administrative Provisions

1. Reporting of certain payments made to attorneys (sec. 1021 of the Act and sec. 6045 of the Code)

Present and Prior Law

Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, . . . or other fixed or determinable gains, profits, and income" (Code sec. 6041(a)). Treas. reg. sec. 1.6041–1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099–Misc. If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.

Reasons for Change

The Congress believed that there would be a positive impact on compliance with the tax laws by requiring additional information reporting. Although some might consider it inappropriate to single out payments to one profession for additional information reporting, requiring reporting was considered to be appropriate in this instance because attorneys are generally the only professionals who receive this type of payment, a portion of which may be income to them and a portion of which may belong to their client.

Explanation of Provision

The Act requires gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099–B (currently used by brokers to report gross proceeds). The only exception to this new reporting requirement would be for any payments reported on either Form 1099–Misc under section 6041 (reports of payment of income) or on Form W-2 under section 6051 (payments of wages).

In addition, the present exception in the regulations exempting from reporting any payments made to corporations will not apply to payments made to attorneys. Treasury regulation section 1.6041–3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported). Reporting will be required under both Code sections 6041 and 6045 (as proposed) for payments to corporations that provide legal services. The exception of Treasury regulation section 1.6041–3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to be reported on Form K–1).

First, the provision applies to payments made to attorneys regardless of whether the attorney is the exclusive payee. Second, payments to law firms are payments to attorneys, and therefore are subject to this reporting provision. Third, attorneys are required to promptly supply their TINs to persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to penalty under section 6723 and the payments being subject to backup withholding under section 3406. Fourth, the IRS should administer this provision so that there is no overlap between reporting under section 6041 and reporting under section 6045. For example, if two payments are simultaneously made to an attorney, one of which represents the attorney's fee and the second of which represents the settlement with the attorney's client, the first payment would be reported under section 6041 and the second payment would not be reported under either section 6041 or section 6045, since it is known that the entire payment represents the settlement with the client (and therefore no portion of it represents income to the attorney). Fifth, it is anticipated that the IRS will administer this provision so that it will not apply to foreign attorneys who can clearly demonstrate that they are not subject to U.S. tax.

Effective Date

The provision is effective for payments made after December 31, 1997. Consequently, the first information reports will be filed with the IRS (and copies will be provided to recipients of the payments) in 1999, with respect to payments made in 1998.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1999, $3 million in 2000, $3 million in 2001, $3 million in 2002, $3 million in 2003, $4 million in 2004, $4 million in 2005, $4 million in 2006, and $4 million in 2007.

2. Information reporting on persons receiving contract payments from certain Federal agencies (sec. 1022 of the Act and sec. 6041A of the Code)

Present and Prior Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. reg. sec. 1.6041A–1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for $25,000 or less (Treas. reg. sec. 1.6050M–1(c)(1)(i)).

Reasons for Change

The Congress determined that lowering the information reporting threshold from $25,000 to $600 will improve compliance because additional, small-dollar value contracts will be reported.

Explanation of Provision

The Act requires reporting of all payments of $600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the provision requires that a copy of the information return be sent by the Federal agency to the recipi-

ent of the payment. An exception is provided for certain classified or confidential contracts.

Effective Date

The provision is effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $7 million in 1999, $8 million in 2000, $9 million in 2001, $10 million in 2002, $11 million in 2003, $11 million in 2004, $12 million in 2005, $12 million in 2006, and $13 million in 2007.

3. Disclosure of tax return information for administration of certain veterans programs (sec. 1023 of the Act 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 Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the IRS and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

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

The DVA disclosure provision is scheduled to expire after September 30, 1998.

Reasons for Change

The Congress determined that it is appropriate to permit disclosure of otherwise confidential tax information to ensure the correctness of government benefits payments.

Explanation of Provision

The Act extends the DVA disclosure provision through September 30, 2003.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $22 million in 1999, $27 million in 2000, $31 million in 2001, $36 million in 2002, $36 million in 2003. The provision is not estimated to change Federal fiscal year budget receipts in 2004 through 2007.

4. Establish IRS continuous levy and improve debt collection (secs. 1024, 1025, and 1026 of the Act and secs. 6103, 6331, and 6334 of the Code)

a. Continuous levy

Present and Prior Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[233] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[234] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[235]

In general, a levy does not apply to property acquired after the date of the levy,[236] regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure is insufficient to satisfy the liability.[237] The only exception to this rule is for salary and wages.[238] A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

A minimum exemption is provided for salary and wages.[239] It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which the taxpayer is entitled, divided by 52.[240] For a family of four for taxable year 1996, the weekly minimum exemption is $325.[241]

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[233] Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[234] Code sec. 6331.

[235] Code sec. 6335–6343.

[236] Code sec. 6331(b).

[237] Code sec. 6331(c).

[238] Code sec. 6331(e).

[239] Code sec. 6334(a)(9).

[240] Code sec. 6334(d).

[241] Standard deduction of $6,700 plus four personal exemptions at $2,550 each equals $16,900, which when divided by 52 equals $325.

Reasons for Change

The Congress determined that the extension of the continuous levy provisions will substantially ease the administrative burdens of collecting taxes by levy. The Congress anticipated that taxpayers who already comply with the tax laws will have a positive view of increased collections of taxes owed by taxpayers who have not complied with the tax laws.

Explanation of Provision

The Act amends the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are subject to levy under present law, would become subject to continuous levy.

In addition, the Act provides that this levy would attach up to 15 percent of any specified payment due the taxpayer. This rule explicitly replaces the other specifically enumerated exemptions from levy in the Code. A continuous levy of up to 15 percent would also apply to unemployment benefits and means-tested public assistance.

The Act also permits the disclosure of otherwise confidential tax return information to the Treasury Department's Financial Management Service only for the purpose of, and to the extent necessary in, implementing these levy provisions.

Use of a continuous levy is at the discretion of the Secretary of the Treasury and its use must be approved by the Internal Revenue Service before it takes effect.[242]

Effective Date

The provision was effective for levies issued after the date of enactment (August 5, 1997).

b. Modifications of levy exemptions

Present and Prior Law

The Code exempts from levy workmen's compensation payments[243] and annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act[244] described above, unemployment benefits[245] and means-tested public assistance.[246]

Reasons for Change

The Congress believed that if wages are subject to levy, wage replacement payments should also be subject to levy. In addition, the Congress believed that it is inappropriate to exempt from levy one

[242] See Title VI (sec. 609(d)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.
[243] Code sec. 6334(a)(7).
[244] Code sec. 6334(a)(6).
[245] Sec. 6334(a)(4).
[246] Sec. 6334(a)(11).

type of annuity or pension payment while most other types of these payments are subject to levy.

Explanation of Provision

The Act provides that the following property is not exempt from levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

(1) workmen's compensation payments;

(2) annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act;

(3) unemployment benefits; and

(4) means-tested public assistance.

Effective Date

The provision applies to levies issued after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $332 million in 1998, $327 million in 1999, $256 million in 2000, $213 million in 2001, $157 million in 2002, $117 million in 2003, $102 million in 2004, $86 million in 2005, $82 million in 2006, and $78 million in 2007.

5. Consistency rule for beneficiaries of trusts and estates (sec. 1027 of the Act and sec. 6034A of the Code)

Present and Prior Law

An S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment (sec. 6037(c)). Similar rules apply in the case of partnerships and their partners (sec. 6222).

The fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1) (sec. 6034A). In addition, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust (sec. 6048(b)). However, under prior law, rules comparable to the consistency rules that apply to S corporation shareholders and partners in partnerships were not specified in the case of beneficiaries of estates and trusts.

Reasons for Change

Both partners in partnerships and shareholders of S corporations are required either to file their returns on a basis that is consistent

with the information received from the partnership or S corporation or to identify any inconsistent treatment. The Congress believed it appropriate to apply such requirement also to beneficiaries of estates and trusts.

Explanation of Provision

Under the Act, a beneficiary of an estate or trust is required to file its return in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

Effective Date

The provision is effective for returns filed after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million per year in each of 1998 through 2003, and $4 million per year in each of 2004 through 2007.

6. Registration of confidential corporate tax shelters and substantial understatement penalty (sec. 1028 of the Act and secs. 6111, 6662, and 6707 of the Code)

Present and Prior Law

Tax shelter registration

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or $500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a $250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (sec. 6112). A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or state law regulating securities,

(2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350 percent of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

The substantial understatement penalty applies in the following manner. If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Reasons for Change

The Congress concluded that the provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions. Also, the provision will im-

prove economic efficiency, because investments that are not economically motivated, but that are instead tax-motivated, may reduce the supply of capital available for economically motivated activities, which could cause a loss of economic efficiency.

Explanation of Provision

Tax shelter registration

The Act requires a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments

with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Substantial understatement penalty

The Act makes two modifications to the substantial understatement penalty. The first modification affects the reduction in the amount of the understatement which is attributable to an item if there is a reasonable basis for the treatment of the item. The provision provides that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multiparty financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax shelter as defined under the modification described below or under present law.

The second modification affects the special tax shelter rules, which define a tax shelter as an entity the principal purpose of which is the avoidance or evasion of Federal income tax. The provision instead provides that a significant purpose (rather than the principal purpose) of the entity must be the avoidance or evasion of Federal income tax for the entity to be considered a tax shelter. This modification conforms the definition of tax shelter for purposes of the substantial understatement penalty to the definition of tax shelter for purposes of these new confidential corporate tax shelter registration requirements.

Treasury report

The provision also directs the Treasury Department, in consultation with the Department of Justice, to issue a report to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under section 7408 of the Code (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (whether or not directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation. The report is due one year after the date of enactment.

Effective Date

The tax shelter registration provision applies to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements. The modifications to the substantial understatement penalty apply to items with respect to transactions entered into after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $15 million in 1998, $37 million in 1999, $38 million in 2000, $39 million in 2001, $41 million in 2002, $42 million in 2003, $43 million in 2004, $44 million in 2005, $46 million in 2006, and $47 million in 2007.

D. Excise and Employment Tax Provisions

1. Extension and modification of Airport and Airway Trust Fund excise taxes (sec. 1031 of the Act and secs. 4081, 4091, and 4261 of the Code)

Present and Prior Law

A variety of excise taxes have been imposed on air transportation under present and prior law to finance the Airport and Airway Trust Fund programs administered by the Federal Aviation Administration (the "FAA"). In general, the full cost of FAA capital programs is financed from the Airport and Airway Trust Fund, while only a portion of FAA operational expenses is Trust Fund-financed. Overall, the portion of total FAA expenditures that has been financed from the Trust Fund declined from 75 percent through the early 1990s to 62 percent for the 1997 fiscal year. The balance is financed by general taxpayers, rather than directly by program users. Under prior law, each of the Airport and Airway Trust Fund excise taxes was scheduled to expire after September 30, 1997.

Commercial air passenger transportation taxes

Under prior law, domestic air passenger transportation was subject to an *ad valorem* excise tax equal to 10 percent of the amount paid for the transportation. Under both prior law and present law, taxable domestic air transportation includes both travel within the United States, certain travel between the United States and points in Canada or Mexico that are within 225 miles of the U.S. border (the "225-mile zone"), and certain transportation within the 225-mile zone.

International air passenger transportation was subject to a $6 departure excise tax imposed on passengers departing the United States for other countries under prior law. No tax was imposed on passengers arriving in the United States from other countries. Both present law and prior law define international transportation to include separate domestic flights from which passengers connect to international flights, provided that stopover time at any point within the United States does not exceed 12 hours. Thus, passengers traveling on these "domestic legs" associated with international transportation (e.g., a flight from Los Angeles to New York from which the passenger boards a connecting flight to London) are exempt from the excise tax otherwise imposed on such transportation between two domestic points even though other passengers traveling on the same flights without continuing to a foreign point are subject to tax.

Because both the domestic and international air passenger excise taxes have been imposed only on transportation for which an amount is paid under both present law and prior law, no tax is im-

posed on passengers engaged in "free" travel (e.g., frequent flyer travel and airline industry employee travel for which the passenger is not directly charged).

The air passenger transportation excise taxes are imposed on passengers; transportation providers (generally airlines) are responsible for collecting and remitting the taxes to the Federal Government. Under prior law, air carriers were not liable for payment of the tax itself. In general, both the domestic and international air passenger transportation excise taxes are imposed without regard to whether the transportation is purchased in the United States. An exception provides that travel between the United States and points within the 225-mile zone and certain transportation within the 225-mile zone is taxed as domestic transportation only if it is purchased within the United States.

The Code requires all advertising for taxable air passenger transportation either (1) to state the fare on a tax-inclusive basis or (2) if the Federal tax is stated separately, to state the amount of the tax at least as prominently as the underlying air fare and to identify that amount as "user taxes to pay for airport construction and airway safety and operations" (sec. 7275(b)).

The amount of air passenger transportation excise tax to be collected from a passenger must be stated on the ticket.

Commercial air cargo transportation

Under both present law and prior law, domestic air cargo transportation is subject to a 6.25-percent *ad valorem* excise tax. This tax, like the air passenger transportation excise taxes, is imposed on the consumer, with the transportation provider being required to collect and remit the tax to the Federal Government. However, there is no requirement that the tax be stated separately on shipping invoices.

Noncommercial aviation

Noncommercial aviation, or transportation on private aircraft which is not "for hire," is subject to excise taxes imposed on fuel in lieu of the commercial air passenger ticket and air cargo excise taxes. Under prior law, the Airport and Airway Trust Fund tax rates on these fuels were 15 cents per gallon on aviation gasoline and 17.5 cents per gallon on jet fuel.

The aviation gasoline excise tax is imposed on removal of the fuel from a registered terminal facility (the same point of collection as the highway gasoline excise tax). The jet fuel excise tax is imposed on sale of the fuel by a wholesale distributor. Many larger airports have dedicated pipeline facilities that directly service aircraft; in such a case, the tax effectively is imposed at the retail level. The person removing the gasoline from a terminal facility or the wholesale distributor of the jet fuel is liable for these taxes.

General Fund aviation fuels excise tax

Under both present law and prior law, fuels used in air transportation are subject to a 4.3-cents-per-gallon excise tax (in addition to any fuels tax described above). Under prior law, receipts from this tax were retained in the General Fund. This fuels tax is iden-

tical to taxes also imposed on motor fuels used in other transportation sectors, including highway, inland waterway, and rail.

Deposit of air transportation excise taxes

Under present law and prior law, the air passenger ticket and freight excise taxes are collected from passengers and freight shippers by the commercial air carriers. After collecting tax, air carriers remit the funds to the Treasury Department; however, the carriers are not required to remit monies immediately. Excise tax returns are filed quarterly (similar to annual income tax returns) with taxes being deposited on a semi-monthly basis (similar to estimated income taxes). For air transportation sold during a semi-monthly period, air carriers may elect to treat the taxes as collected on the last day of the first week of the second following semi-monthly period. Under these "deemed collected" rules, for example, the taxes on air transportation sold between August 1 and August 15, are treated as collected by the air carriers on or before September 7, with the amounts generally being deposited with the Treasury Department by September 10. A special rule requires certain taxes on air transportation sold during the first half of September to be deposited by September 29.

Semi-monthly deposits and quarterly excise tax returns also are required with respect to the fuels excise taxes imposed on air transportation.

Overflight user fees

Non-tax user fees are imposed on air transportation (both commercial and noncommercial aviation) that travels through airspace for which the United States provides air traffic control services, but that neither lands in nor takes off from a point in the United States. These fees are imposed and collected by the FAA with respect to mileage actually flown, and apply both to travel within U.S. territorial airspace and to travel within international oceanic airspace for which the United States is responsible for providing air traffic control services.

Reasons for Change

The Congress determined that provisions to ensure a long-term, stable funding source for the Airport and Airway Trust Fund should be enacted at this time. Events shortly before enactment of the Act when a shortfall in fiscal year 1997 FAA funding was narrowly averted by an emergency extension of the prior-law excise taxes through September 30, 1997 (H.R. 668),[247] illustrated the need for a longer-term resolution of these funding needs. Therefore, the Act extends (with certain modifications) the prior-law Airport and Airway Trust Fund excise taxes for a 10-year period, in order to address for this period, concerns about the structure of these taxes and the availability of adequate user tax revenues to fund the portion of FAA programs to be appropriated from the Airport and Airway Trust Fund.

[247] See Part One of this pamphlet for a description of H.R. 668 (P.L. 105–2; February 28, 1997).

The Congress determined that limited modifications to the commercial air passenger excise tax structure are warranted as part of this longer-term resolution of Airport and Airway Trust Fund financing requirements. First, the structure of the tax is modified by the Act to include a reduced *ad valorem* rate plus a fixed dollar amount tax rate applicable to all revenue passengers. The Act further clarifies that tax is imposed on payments to air carriers (and related parties) from credit card and other companies in exchange for the right to frequent flyer or other reduced-cost air travel rights. In addition, the Congress determined that the perceived fairness of the passenger air transportation excise taxes will be improved if certain currently untaxed payments for air transportation are taxed to help support the FAA programs. In furtherance of this goal, the Act extends the international air passenger transportation tax to internationally arriving passengers.

Explanation of Provisions

Extension of Airport and Airway Trust Fund taxes

The Act extends the Airport and Airway Trust Fund excise taxes, as modified below, for 10 years, for the period October 1, 1997, through September 30, 2007. The taxes that are extended include the domestic and international air passenger excise taxes, the air cargo excise tax, and the noncommercial aviation fuels taxes. Gross receipts from these taxes will continue to be deposited in the Airport and Airway Trust Fund throughout this period.

Modification of commercial air passenger transportation taxes

Domestic passenger tax rates.—The prior-law 10-percent domestic air passenger excise tax is changed to a tax equal to the *total* of 7.5 percent of the gross amount paid by the passenger for the transportation *plus* a $3 fixed dollar amount per flight segment. Both the *ad valorem* rate and fixed-dollar flight segment tax are phased in, as follows:

October 1, 1997–September 30, 1998: 9 percent of the fare, plus $1 per domestic flight segment;

October 1, 1998–September 30, 1999: 8 percent of the fare, plus $2 per domestic flight segment;

October 1, 1999–December 31, 1999: 7.5 percent of the fare, plus $2.25 per domestic flight segment.

After December 31, 1999, the *ad valorem* rate will remain at 7.5 percent. The domestic flight segment component of the tax will increase to $2.50 (January 1, 2000–December 31, 2000), to $2.75 (January 1, 2001–December 31, 2001), and to $3 (January 1, 2002-December 31, 2002). On January 1, 2003, and on each January 1 thereafter, the fixed dollar amount per flight segment will be indexed annually for inflation occurring after 2001, measured by changes in the Consumer Price Index (the "CPI") rounded to the nearest 10 cents. Inflation adjustments will be effective for transportation provided beginning after December 31, 2002, and in each subsequent calendar year.

The term "flight segment" is defined as transportation involving a single take-off and a single landing.[248] The Act provides a rule of administrative convenience that there is no change in the number of flight segment taxes imposed (increase or decrease) if a passenger's route between two locations is changed (with a resulting change in the number of actual flight segments) and there is no change in the fare charged (including no imposition of an additional administrative or other fee associated with the route change). Generally, this rule applies to flight changes for travel between the same origin and destination as a result of, e.g., aircraft mechanical problems. The rule similarly covers itinerary changes such as a diversion to another intermediate or destination airport as a result of inclement weather conditions.

All transportation between points within the 48 contiguous States (and within Hawaii or Alaska), other than domestic segments associated with uninterrupted international transportation, is subject to tax at the revised *ad valorem* and flight segment rates.

International passenger tax rates.—The prior-law $6 international departure tax is increased to $12 per departure, and an identical $12 per passenger tax is imposed on arrivals in the United States from international locations. The international departure and arrival taxes are indexed for inflation occurring after 1997, measured by changes in the CPI rounded to the nearest 10 cents. Inflation adjustments will be effective for transportation provided beginning after December 31, 1998, and each subsequent calendar year. The Congress believed that this increased tax level is consistent with the user tax principles of the Airport and Airway Trust Fund taxes which include the recovery from international passengers of a greater percentage of the costs those passengers impose on FAA programs than were collected by the prior-law international departure tax, so that purely domestic passengers and the General Fund will not be required to subsidize the costs imposed by international travelers to the extent that occurred under prior law.

Special rules applicable to certain transportation.—As under prior law, certain air transportation between the United States and points within the 225-mile zone of Canada or Mexico or within the 225-mile zone is taxed as domestic transportation when the transportation is purchased in the United States. Identical transportation purchased in either Canada or Mexico is subject to the revised tax on international departures and arrivals.

Transportation between the 48 contiguous States and Alaska or Hawaii (or between those States) remains subject to the special rules provided in prior law. Thus, this transportation is taxed on apportioned mileage in U.S. territorial airspace (and a fixed dollar per domestic flight segment tax), plus a single international passenger tax per one-way flight segment (despite the fact that the flight both departs into and arrives from international airspace). In addition, under a special rule, the applicable international tax rate for this transportation is $6 (rather than $12) per passenger. As

[248] For example, travel from New York to San Francisco, with an intermediate stop in Chicago, would consist of two flights segments (without regard to whether the passenger changed aircraft in Chicago).

with the domestic flight segment tax and the $12 international tax rates, the $6 rate is indexed for inflation using the CPI.

A further special rule is provided for certain flight segments to or from qualified rural airports. A qualified rural airport is an airport that (1) in the second preceding calendar year had fewer than 100,000 commercial passenger enplanements (i.e., departures), and (2) either (a) is not located within 75 miles of another airport that had more than 100,000 such passenger enplanements in that year, or (b) is eligible for payments under the Federal "essential air services" program (as that program was in effect on the date of the Act's enactment). Flight segments to or from a qualified rural airport are subject to the fully phased-in 7.5 percent *ad valorem* rate effective after September 30, 1997, and the fixed dollar flight segment component of the domestic passenger transportation tax does not apply to such segments.[249] The otherwise applicable *ad valorem* rate and the flight segment component of the tax apply in full to flight segments other than those departing from or arriving at qualified rural airports.

The term flight segment means transportation involving a single take-off and a single landing. In the case of transportation involving multiple flight segments, the portion of the fare allocable to the rural segment for purposes of applying the reduced *ad valorem* tax rate is determined based on the number of Great Circle miles in the rural flight segment as compared to the aggregate number of such miles in all of the flight segments.

Extension of tax to certain previously exempt passengers.—As described above, revenue passengers arriving in the United States from other countries, who were the only group of travelers under prior law whose transportation was subject neither to an excise tax nor a user fee for U.S.-provided aviation services, are subject to a $12 international passenger tax on their arriving international flights.

The Act also clarifies that any amounts paid to air carriers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate air transportation are treated as amounts paid for taxable air transportation, subject to the 7.5 percent *ad valorem* tax rate. This tax applies to payments, whether made within the United States or elsewhere, if the rights to transportation for which payments are made can be used in whole or in part for transportation that, if purchased directly, would be subject to either the domestic or international passenger taxes. Also, except as described below, the tax applies without regard to whether transportation ultimately is provided pursuant to the transferred rights. Examples of amounts taxable under this provision include (1) payments for frequent flyer miles (including other rights to air transportation) purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, air carriers (or related parties), mutual funds, and other businesses, and (2) amounts received by airlines (whether paid in cash or in kind) pursuant to joint venture credit card or other air transportation marketing arrangements as compensation for the

[249] The Act directs the Treasury Department to publish an annual list of qualified rural airports, based on passenger enplanements for the requisite calendar year.

right to air transportation. The Act further specifically authorizes the Treasury Department to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 7.5-percent tax is applied. The Act includes an exception to this general rule in the case of payments for air transportation rights between corporations that are members of a 100-percent commonly owned controlled group (e.g., transportation purchased from an air carrier by a 100-percent commonly owned corporation operating a frequent flyer award program for the air carrier).

The Congress was aware that consumers accrue mileage awards from numerous sources, including actual air travel as well as programs giving rise to taxable payments under this provision. Once awarded to consumers, these miles are commingled in the consumer's account such that any miles that ultimately may be used for a specific purpose may not be traceable to the source which gave rise to them. The Act authorizes the Treasury Department to develop regulations excluding from the tax base a portion of otherwise taxable payments, if any, with respect to awarded frequent flyer miles if the Treasury determines that a portion properly can be allocated (traced) to miles that are used by consumers for purposes other than air transportation. Miles that are unused should not be treated as used for purposes other than air transportation. As part of any rulemaking process it undertakes, the Treasury is authorized to review airline frequent flyer programs and other information from all available sources, including industry and third-party data, in determining whether mileage awards can be adequately traced to support allocations based on the ultimate use of the awards. The Congress intended that any adjustment to the tax base will be prescribed only if the Treasury finds a consistent pattern of non-air transportation usage by consumers at levels indicating that significant mileage awarded pursuant to payments taxable under this provision is being used for purposes other than air transportation. In making any such adjustment, the Treasury Department should treat mileage used for otherwise non-taxable air transportation or for non-air transportation purposes as coming first from mileage awarded to consumers from actual air travel (and other sources not subject to tax under this provision).

No inference is intended from this provision as to the proper treatment of these payments under prior law.

Advertising requirements.—The Act retains the prior-law Code advertising requirements governing statement of taxes in advertisements and passenger tickets. These requirements apply equally to the reduced *ad valorem* rate and the fixed dollar per flight segment component of the tax.

Liability for tax.—The prior-law provision imposing liability for the tax on passengers (with transportation providers being liable for collecting and remitting revenues to the Federal Government) is modified to impose liability for uncollected tax (including tax on sales of frequent flyer miles and similar rights to reduced-cost air transportation) on air carriers. In the case of transportation for which payment is made outside the United States, this liability is imposed on the air carrier carrying the passenger on the first flight segment in the United States.

Transfer of 4.3-cents-per-gallon fuels excise tax to Airport and Airway Trust Fund

The 4.3-cents-per-gallon excise tax on aviation gasoline and jet fuel will be deposited in the Airport and Airway Trust Fund, rather than in the General Fund, beginning with fuels sold or removed after September 30, 1997.

Modify air passenger excise tax deposit rules

The deposit rules with respect to the commercial air passenger excise taxes are modified to permit taxes that otherwise would have been required to be deposited during the period August 15, 1997, through September 30, 1997, to be deposited on October 10, 1997. Additionally, the Act provides that deposits of commercial air passenger taxes that otherwise would be required after August 14, 1998, and before October 1, 1998, will be due on October 5, 1998. Deposits of the commercial air cargo and aviation fuels taxes that otherwise would be required to be made after July 31, 1998, and before October 1, 1998, will be due on October 5, 1998.

Effective Date

These provisions generally are effective on the date of enactment (August 5, 1997), for air transportation beginning after September 30, 1997. The modifications to the domestic air passenger transportation tax did not apply to transportation purchased before October 1, 1997, and the modifications to the international passenger tax did not apply to transportation purchased before eight days after the date of the Act's enactment (i.e., before August 13, 1997), if the transportation began after September 30, 1997.

The extension of the general aviation fuels excise taxes is effective for fuels removed or sold after September 30, 1997.

The provision relating to certain amounts paid for the right to award air transportation is effective for amounts paid (or benefits transferred) after September 30, 1997, except payments (or transfers) between related parties occurring after June 11, 1997 and before October 1, 1997, are subject to tax if the payments relate to rights to transportation to be awarded or otherwise distributed after September 30, 1997.

The provision transferring the 4.3-cents-per-gallon General Fund fuels tax revenues to the Airport and Airway Trust Fund was effective for taxes received after September 30, 1997. The provision modifying the commercial air passenger excise tax deposit rules was effective on the date of enactment.

Revenue Effect

The provision is estimated to decrease Federal fiscal year budget receipts by $1,017 million in 1997 and to increase Federal fiscal year budget receipts by $5,649 million in 1998, $7,434 million in 1999, $6,498 million in 2000, $7,014 million in 2001, $7,580 million in 2002, $8,124 million in 2003, $8,676 million in 2004, $9,267 million in 2005, $9,901 million in 2006, and $10,566 million in 2007.

2. Extend diesel fuel excise tax rules to kerosene (sec. 1032 of the Act and secs. 4081-4083 of the Code)

Present and Prior Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.4 cents per gallon.[250] This tax is collected on *all* diesel fuel upon removal from a pipeline or barge terminal unless the fuel is indelibly dyed and is destined for a nontaxable use. Diesel fuel also commonly is used as heating oil; diesel fuel used as heating oil is not subject to tax. Certain other uses also are exempt from tax, and some transportation uses (e.g., rail and intercity buses) are taxed at reduced rates. Both exemptions and reduced-rates are realized through credits or refund claims if undyed diesel fuel is used in a qualifying use.

Before October 1, 1997, aviation gasoline and jet fuel (both commercial and noncommercial use) were subject to a 4.3-cents-per-gallon General Fund tax rate. In addition, through September 30, 1997, gasoline and jet fuel used in noncommercial aviation were subject to an additional 15-cents-per-gallon rate (gasoline) and 17.5-cents-per-gallon rate (jet fuel), respectively, for the Airport and Airway Trust Fund. These combined rates produced an aggregate tax of 21.8 cents per gallon on noncommercial aviation jet fuel and 19.3 cents per gallon on noncommercial aviation gasoline. Separate provisions of the Act provided for transfer of revenues from the 4.3-cents-per-gallon fuels tax to the Airport and Airway Trust Fund, and increased the aggregate tax rate by 0.1-percent per gallon (reflecting reinstatement of the Leaking Underground Storage Tank Trust Fund rate). The tax on non-gasoline aviation fuel is imposed on the sale of the fuel by a "producer," typically a wholesale distributor. Thus, this tax is imposed at a point in the fuel distribution chain subsequent to removal from a terminal facility. The tax on aviation gasoline is imposed on removal of the gasoline from a pipeline or barge terminal facility.

Kerosene is used both as a transportation fuel and as an aviation fuel. Kerosene also is blended with diesel fuel destined both for taxable (highway) and nontaxable (heating oil) uses to, among other things, prevent gelling of the diesel fuel in colder temperatures. Under present law, kerosene is not subject to excise tax unless it is blended with taxable diesel fuel or is sold for use as aviation fuel. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department requirements for untaxed, dyed diesel fuel. Clear, low-sulphur kerosene (K-1) also is used in space heaters, and often is sold for this purpose at retail service stations. As with other heating oil uses, kerosene used in space heaters is not subject to Federal excise tax.

Although heating oil often has minor amounts of kerosene blended with it in colder weather, this blending typically occurs before removal of the fuel from the terminal facilities where Federal excise taxes are imposed. However, it may be necessary during peri-

[250] The tax rate was 24.3 cents per gallon before reinstatement of the Leaking Underground Storage Tank Trust Fund rate as of October 1, 1997, by section 1033 of the Act. (See item D.3., following.)

ods of extreme or unseasonably cold weather to add kerosene to heating oil after its removal from the terminal. Other nontaxable uses of kerosene include feedstock use in the petrochemical industry.

Reasons for Change

The Congress was informed that the Internal Revenue Service has discovered significant evidence that kerosene was being blended with taxable highway diesel fuel during periods when the blending is not necessary due to colder weather conditions. Some wholesale distributors of diesel fuel also suggested that their competitors were not paying the tax on the kerosene that they blended with diesel fuel for highway use. These reports of increased use of kerosene as a taxable highway fuel without payment of tax coincided with implementation of enhanced diesel fuel tax compliance measures that significantly reduced opportunities to evade that tax. The Congress determined, therefore, that these same compliance measures should be extended to kerosene.

Explanation of Provision

The Act extends the diesel fuel excise tax collection rules to kerosene. Thus, kerosene is taxed when it is removed from a registered terminal unless it is indelibly dyed and destined for a nontaxable use. However, aviation-grade kerosene that is removed from the terminal by a registered producer of aviation fuel (e.g., fuel by such a producer for delivery to a retail fixed-base operator for use in noncommercial aviation) is not subject to the dyeing requirement and will continue to be taxed under the prior- and present-law rules applicable to aviation fuel. Feedstock kerosene that a registered industrial user receives by pipeline or vessel also is exempt from the dyeing requirement. Other feedstock kerosene would be exempt from the dyeing requirement to the extent and under conditions (including satisfaction of registration and certification requirements) prescribed by Treasury Department regulation.

To accommodate State safety regulations that require the use of clear (K-1) kerosene in certain space heaters, a refund procedure is provided under which registered ultimate vendors may claim refunds of the tax paid on kerosene sold for that use. In addition, the Internal Revenue Service is given discretion to refund to a registered ultimate vendor the tax paid on kerosene that is blended with heating oil for use during periods of extreme or unseasonable cold.

Further, to ensure that registered terminals offer untaxed dyed kerosene and diesel fuel to customers, the Code provisions governing eligibility of terminals to receive non-tax-paid fuel are modified to require that a terminal offer both dyed and undyed kerosene (if it receives non-tax-paid kerosene (including kerosene aviation jet fuel and diesel fuel #1) as a condition of receiving non-tax-paid kerosene and that terminals offer both dyed and undyed diesel fuel as a condition of receiving non-tax-paid diesel fuel.

Effective Date

The provision is effective for kerosene removed from terminal facilities after June 30, 1998. Appropriate floor stocks taxes will be imposed on kerosene held beyond the point of taxation on July 1, 1998.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $44 million in 1998, $43 million in 1999, $49 million in 2000, $46 million in 2001, $44 million in 2002, $43 million in 2003, $44 million in 2004, $47 million in 2005, $49 million in 2006, and $52 million in 2007.

3. Reinstate Leaking Underground Storage Tank Trust Fund excise tax (sec. 1033 of the Act and secs. 4041(d), 4081(a)(2), and 4081(d)(2) of the Code)

Present and Prior Law

Before January 1, 1996, an excise tax of 0.1 cent per gallon was imposed on gasoline, diesel fuel (including train diesel fuel), special motor fuels (other than liquefied petroleum gas), aviation fuels, and inland waterways fuels. Revenues from the tax were dedicated to the Leaking Underground Storage Tank Trust Fund to finance cleanups of leaking underground storage tanks.

Reasons for Change

The Congress determined that the Leaking Underground Storage Tank Trust Fund excise tax should be reinstated to ensure the availability of funds to pay cleanup costs of leaking underground storage tanks.

Explanation of Provision

The Act reinstates the prior-law Leaking Underground Storage Tank Trust Fund excise tax through March 31, 2005.

Effective Date

The provision was effective on October 1, 1997.

Revenue Effect

This provision is estimated to increase Federal fiscal year budget receipts by $129 million in 1998 and 1999, $128 million in 2000, $129 million in 2001, $131 million in 2002, $134 million in 2003, $136 million in 2004, and $67 million in 2005.

4. Application of communications excise tax to prepaid telephone cards (sec. 1034 of the Act and sec. 4251 of the Code)

Present and Prior Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange

service. The tax is collected by the provider of the service from the consumer (business and personal service).

Reasons for Change

The Congress understood that communications service providers sometimes sell units of telephone service to third parties who, in turn, resell or distribute these units of telephone service to the ultimate customer in the form of prepaid telephone cards or similar arrangements. The Congress believed that such payments clearly represent payments for telephone service and clarified that such payments are subject to the communications excise tax.

Explanation of Provision

Under the Act, any amounts paid to communications service providers (in cash or in kind) for the right to award or otherwise distribute telephone service (i.e., local or toll telephone service) are treated as amounts paid for taxable communications services, subject to the 3-percent *ad valorem* tax rate. Examples of such taxable amounts include (1) prepaid telephone cards offered through service stations, convenience stores and other businesses to their customers and others and (2) amounts received by communications service providers pursuant to joint venture credit card or other marketing arrangements.[251] The Treasury Department is authorized specifically to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 3-percent tax is applied.

The Act also clarifies that the base to which the communications tax applies in the case of prepaid telephone cards and similar arrangements is the retail value of the service provided by the use of the card or arrangement. The Congress understood that at the time the Act was enacted, prepaid telephone cards were offered to the public in two forms. The first type of prepaid telephone card can be called a "dollar value card." In this case, the final customer purchases a card or account which allows him to utilize $X worth of telephone service provided by an underlying telecommunications carrier. In this case, the Act provides that the 3-percent communications excise tax will apply to the value X at the time the prepaid telephone card is sold by a telecommunications carrier to a person who is not a telecommunications carrier.

The second type of prepaid telephone card may be called a "unit card" or a "minute card." In this case the final customer purchases a card or account which allows him to use Y number of units or minutes of telephone service provided by an underlying telecommunications carrier. The Congress intended that the tax applicable to such cards be based on the retail value of the telephone service offered to a consumer and the Act grants the Treasury Department regulatory authority to determine the appropriate retail value. The legislative history notes that at the time the Act was enacted, the Federal Communications Commission generally required telecommunications carriers to file a tariff listing the prices

[251] A technical correction may be required to clarify that payments to a communications service provider from a third party such as a joint venture credit card company are treated as payments made by the holder of the credit card to obtain communications services.

of their various service offerings including the price of units or minutes offered via prepaid telephone cards. For this case, the legislative history provides that the 3-percent communications excise tax will apply to Y (the number of units or minutes) multiplied by the tariffed price of those units or minutes at the time the prepaid telephone card is sold by a telecommunications carrier to a person who is not a telecommunications carrier.

The legislative history recognizes that such a tariffed value may not in all cases correspond to the over-the-counter price that a final customer may pay for the card. However, the legislative history states that looking to the tariffed price, at present, is the best way to achieve neutral treatment of "dollar cards" and "unit" or "minute cards." The legislative history provides that, where a prepaid telephone card does not have an underlying tariff that applies to that particular card, tariffs for comparable telephone service shall be applied. The legislative history expresses Congress's preference that tariffs should continue to be filed for service offered by prepaid telephone cards, but if, in the future, tariff filings are not generally filed the Act authorizes the Treasury Department to develop alternative standards for determining the appropriate retail value of the units or minutes of service offered on such cards.

The Act recognizes that sometimes a communications service provider may require certain customers to prepay for their service as assurance that payment is made by the customer for services to be provided. The legislative history accompanying the Act states that such arrangements do not constitute payment for communications services for the purposes of this provision if the customer is entitled to a full refund, in cash, for the value of any unused service. The legislative history considers such arrangements to be deposits to assure payment for service to be provided in the future. However, if such payments are nonrefundable, or only partially refundable, then such payments are subject to the communications excise tax at the time they are made.

No inference is intended from this provision as to the proper treatment of payments received by communications service providers for prepaid telephone cards and amounts received by communications service providers pursuant to joint venture credit card or other marketing arrangements under prior law.

Effective Date

The provision was effective for cards sold on or after the first day of the month which commences more than 60 days after the date of enactment (i.e., effective on November 1, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $19 million in 1998, $28 million in 1999, $38 million in 2000, $49 million in 2001, $60 million in 2002, $71 million in 2003, $83 million in 2004, $101 million in 2005, $113 million in 2006, $124 million in 2007.

5. Extension of temporary Federal unemployment surtax (sec. 1035 of the Act and sec. 3301 of the Code)

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4-percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4-percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8-percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 1998.

Reasons for Change

The Congress determined that the surtax extension is needed in order to increase funds for the Federal Unemployment Trust Fund to provide a cushion against future Trust Fund expenditures. The monies retained in the Federal Unemployment Account of the Federal Unemployment Trust Fund can then be used to make loans to the 53 State Unemployment Compensation benefit accounts as needed.

Explanation of Provision

The Act extends the temporary surtax rate through December 31, 2007. It also increases the limit from 0.25 percent to 0.50 percent of covered wages on the Federal Unemployment Account (FUA) in the Federal Unemployment Trust Fund.

Effective Date

The provision is effective for labor performed on or after January 1, 1999.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1,063 million in 1999, $1,763 million in 2000, $1,797 million in 2001, $1,733 million in 2002, $661 million in 2003, and to decrease Federal fiscal year budget recipts by $73 million in 2004, $71 million in 2005, $74 million in 2006, and $73 million in 2007.

E. Provisions Relating to Tax-Exempt Organizations

1. Extend UBIT rules to second-tier subsidiaries and amend control test (sec. 1041 of the Act and sec. 512(b)(13) of the Code)

Present and Prior Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 80 percent controlled by the parent tax-exempt organization.[252] In the case of a stock subsidiary, the 80 percent control test is met if the parent organization owns 80 percent or more of the voting stock and all other classes of stock of the subsidiary.[253] In the case of a nonstock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.[254]

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.[255] Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBI to the tax-exempt parent organization.[256]

Reasons for Change

Section 512(b)(13) was enacted, in part, to prevent subsidiaries of tax-exempt organizations from reducing their otherwise taxable income by borrowing, leasing, or licensing assets from a tax-exempt parent organization at inflated levels. In addition, however, even if such payments arguably could satisfy an arm's-length standard, section 512(b)(13) is intended to prevent a tax-exempt parent from obtaining what is, in effect, a tax-free return on capital invested in its subsidiary. Because section 512(b)(13) was narrowly drafted, organizations were able to circumvent its application through, for example, the issuance of 21 percent of nonvoting stock with nominal value to a separate friendly party or through the use of tiered or

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[252] For this purpose, a "controlled organization" is defined under section 368(c). Under present law, rent, royalty, annuity, and interest payments are treated as UBI when received by the parent organization based on the percentage of the subsidiary's income that is UBI (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

[253] Treas. Reg. sec. 1.512(b)–1(l)(4)(I)(A).

[254] Treas. Reg. sec. 1.512(b)–1(l)(4)(I)(B).

[255] See PLR 9338003 (June 16, 1993) (holding that because no indirect ownership rules are applicable under section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBI to a tax-exempt parent organization). In contrast, an example of an indirect ownership rule can be found in Code section 318. Section 318(a)(2)(C) provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation.

[256] See PLR 9542045 (July 28, 1995) (holding that first-tier holding company and second-tier operating subsidiary were organized with bona fide business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by tax-exempt parent organization from second-tier subsidiary were not UBI).

brother/sister subsidiaries. The Congress believed that modifications to the control requirement and inclusion of attribution rules will ensure that section 512(b)(13) operates consistent with its intended purposes.

Explanation of Provision

The Act modifies the test for determining control for purposes of section 512(b)(13). Under the Act, "control" means (in the case of a stock corporation) ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests.

In addition, the Act applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The Act also makes technical modifications to the method provided in section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includable in the latter organization's UBI.[257] Such payments are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

Effective Date

The provision generally applies to taxable years beginning after the date of enactment. The provision does not apply to any amount paid or accrued during the first two taxable years beginning on or after the date of enactment if such amount is paid or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such amount is paid or accrued.[258]

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in each of 1998 through 2000, $3 million in 2001, $5 million in 2002, $5 million in 2003, and $4 million per year in each of 2004 through 2007.

2. Repeal grandfather rule with respect to pension business of certain insurers (sec. 1042 of the 1997 Act and sec. 1012(c) of the Tax Reform Act of 1986)

Present and Prior Law

Present law provides that 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. When this rule was enacted in 1986, certain treatment (described below) applied to Blue Cross and Blue Shield organiza-

[257] In this regard, a technical correction is required to correctly cross reference section 513(a) in the parenthetical contained in section 512(b)(13)(B)(i)(I).

[258] A technical correction is required to clarify the statute in this regard.

tions providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such Blue Cross and Blue Shield organizations, which became taxable organizations under the provision, is as follows. A special deduction applies with respect to health business equal to 25 percent of the claims and expenses[259] incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. It was provided that the provision does not apply to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business, nor did the provision apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), and plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the Code, any individual retirement plan described in section 408 of the Code, and any eligible deferred compensation plan to which section 457(a) of the Code applies.

Reasons for Change

The Congress was concerned that the continued tax-exempt status of certain organizations that engage in insurance activities gives such organizations an unfair competitive advantage. The Congress believed that the provision of insurance at a price suffi-

[259] Section 1604(d) of the 1997 Act clarifies this rule to provide that, for purposes of the section 833 deduction, liabilities incurred during the taxable year under cost-plus contracts are added to claims incurred, and expenses incurred under cost-plus contracts are added to expenses incurred.

cient to cover the costs of insurance generally constitutes an activity that is commercial. Thus, the Congress believed it no longer appropriate to continue the grandfather rule that permits certain organizations to retain tax-exempt status with respect to pension business that constitutes commercial-type insurance.

Explanation of Provision

The Act repeals the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association and College Retirement Equities Fund which is attributable to pension business and to that portion of the business of Mutual of America which is attributable to pension business. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America are to be treated for Federal tax purposes as life insurance companies.

A fresh start is provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment is made under section 481 on account of an accounting method change. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America are required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, is treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America is deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation, amortization, or for other purposes).

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1998, $82 million in 1999, $116 million in 2000, $124 million in 2001, $128 million in 2002, $133 million in 2003, $140 million in 2004, $149 million in 2005, $160 million in 2006, and $174 million in 2007.

F. Foreign Provisions

1. Inclusion of income from notional principal contracts and stock lending transactions under subpart F (sec. 1051 of the Act and sec. 954 of the Code)

Present and Prior Law

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such

income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consisted of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon was treated as foreign personal holding company income; under prior law, income from equity swaps or other types of notional principal contracts was not treated as foreign personal holding company income. Under prior law, income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) was treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally was excluded from the definition of foreign personal holding company income. However, under prior law, no exception was available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

Reasons for Change

The Congress understood that income from notional principal contracts and stock-lending transactions is economically equivalent to types of income that were treated as foreign personal holding company income under prior law. Accordingly, the Congress believed that the categories of foreign personal holding company income should be expanded to cover such income. In addition, the Congress believed that an exception from the foreign personal holding company income rules should be available for dealers in financial instruments referenced to commodities.

Explanation of Provision

The Act treats net income from all types of notional principal contracts as a new category of foreign personal holding company income. However, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income is included in that other category. Although net income from notional principal contracts is added as a new category of foreign personal

holding company income, amounts with respect to a notional principal contract entered into to hedge an item described in another category of foreign personal holding company income are taken into account under the rules of such other category. In this regard, gains and losses from transactions in inventory property are covered by an exclusion from the category of personal holding company income for net gains from property transactions; income from a notional principal contract entered into to hedge inventory property is taken into account under such category and thus similarly is excluded from foreign personal holding company income.

The Act treats payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 as another new category of foreign personal holding company income.

The Act provides an exception from foreign personal holding company income for certain income, gain, deduction, or loss from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities).

These modifications to the definition of foreign personal holding company income apply for purposes of determining a foreign corporation's status as a PFIC.

Effective Date

The provision applies to taxable years beginning after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $9 million in 1998, $20 million in 1999, $21 million in 2000, $21 million in 2001, $21 million in 2002, $21 million in 2003, $22 million in 2004, $22 million in 2005, $22 million in 2006, and $23 million in 2007.

2. Restrict like-kind exchange rules for certain personal property (sec. 1052 of the Act and sec. 1031 of the Code)

Present and Prior Law

Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the tax-

payer, and further adjusted for any gain or loss recognized on the exchange.

Application of depreciation rules

Tangible personal property that is used predominantly outside the United States generally is accorded a less favorable depreciation regime than is property that is used predominantly within the United States. Thus, under present law, if a taxpayer exchanges depreciable U.S. property with a low adjusted basis (relative to its fair market value) for similar property situated outside the United States, the adjusted basis of the acquired property will be the same as the adjusted basis of the relinquished property, but the depreciation rules applied to such acquired property generally will be different than the rules that were applied to the relinquished property.

Reasons for Change

The Congress believed that the depreciation and other rules applicable to foreign- and domestic-use property are sufficiently dissimilar so as to treat such property as not "like-kind" property for purposes of section 1031.

Explanation of Provision

The Act provides that personal property predominantly used within the United States and personal property predominantly used outside the United States are not "like-kind" properties. For this purpose, the use of the property surrendered in the exchange will be determined based upon the predominant use during the 24 months immediately prior to the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same predominant use (i.e., foreign or domestic) for the 24 months immediately after the exchange.

The 24-month period is reduced to such lesser time as the taxpayer held the property, unless such shorter holding period is a result of a transaction (or series of transactions) structured to avoid the purposes of the provision. Property described in section 168(g)(4) (generally, property used both within and without the United States that is eligible for accelerated depreciation as if used in the United States) will be treated as property predominantly used in the United States.

Effective Date

The provision is effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract will not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before June 9, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $4 million in 1998, $8 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, $23 million in 2006, and $25 million in 2007.

3. Impose holding period requirement for claiming foreign tax credits with respect to dividends (sec. 1053 of the Act and new sec. 901(k) of the Code)

Present and Prior Law

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for income taxes paid to a foreign government on the dividend. This credit was allowed under prior law without regard to the U.S. person's holding period for the foreign corporation's stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10-percent or greater voting interest may be entitled to a credit for the foreign taxes paid by the foreign corporation. This credit also was allowed under prior law without regard to the U.S. shareholder's holding period for the foreign corporation's stock (secs. 902 and 960).

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. shareholders that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on dividends they receive.

Reasons for Change

Although prior law imposed a holding period requirement for the dividends-received deduction for a corporate shareholder (sec. 246), there was no similar holding period requirement for foreign tax credits with respect to dividends. As a result, some U.S. persons engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that were unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits was prevented by the limitation) to persons that could use such credits. These transactions sometimes involved a short-term transfer of ownership of dividend-paying shares. Other transactions involved the use of derivatives to allow a person that could not benefit from foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person received the foreign tax credit benefits.

Explanation of Provision

The Act denies a shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under the Act, the minimum holding period for dividends on common stock is 16 days. The minimum holding period for dividends on certain preferred stock is 46 days.

Where the holding period requirement is not met with respect to a dividend from a foreign corporation, the Act disallows the foreign tax credits for the foreign withholding taxes that are paid with respect to the dividend. A withholding tax for purposes of the provision includes any tax determined on a gross basis, but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

Where the holding period requirement is not met, the Act denies foreign tax credits for withholding taxes both to the recipient of the dividend and any other taxpayer (i.e., an indirect shareholder) who would otherwise be entitled to claim such foreign tax credits. It was intended that, in addition to actual dividend payments, the provision apply to additional dividend amounts that are deemed to be paid with respect to the dividend under an applicable U.S. tax treaty. Furthermore, the Act applies to indirect foreign tax credits otherwise allowable for taxes paid by a lower-tier foreign corporation and for foreign tax credits of a RIC that elects to treat its foreign taxes as paid by the shareholders. The Act denies such credits where any of the stock in the chain of ownership that is a requirement for claiming the credits is held for less than the required holding period.

The Act denies these same foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the shareholder has an obligation to make payments related to the dividend (whether pursuant to a short sale or otherwise) with respect to substantially similar or related property.

The 16-day holding period for common stock dividends must be satisfied during the 30-day period beginning on the date which is 15 days before the date on which the share becomes ex-dividend. The 46-day holding period for preferred stock dividends must be satisfied during the 90-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend. For purposes of determining whether the required holding period is met, section 246(c)(3) applies such that the day the taxpayer disposes of the stock is taken into account, but the day the taxpayer acquires the stock is not. In addition, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) is disregarded. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after the stock is purchased, the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock, and the taxpayer retains the swap position for the entire period it holds the stock. Under the Act, the taxpayer would not be able to claim any foreign tax credits with respect to dividends on the stock because the taxpayer's holding period is limited to two days as a result of the equity swap (see Treas. Reg. sec. 1.246–3(d)(2)(ex.1)). For purposes of entitlement to indirect foreign tax credits (secs. 902 and 960), if a taxpayer's holding period is reduced as a result of a contract for a *bona fide* sale of stock, the determination of whether the holding period requirement is met is made as of the date such contract is entered into; thus, the holding period requirement for common stock would be met if the taxpayer held the stock for 16 days or more as of the date the contract was

entered into. It was intended that the bona fide contract exception apply only to periods during which the contract is in effect.

The Act also provides an exception for foreign tax credits with respect to certain dividends received by active dealers in securities. In order to qualify for the exception, the following requirements must be met: (1) the dividend must be received by the entity on stock which it holds in its capacity as a dealer in securities, (2) the entity must be subject to net income taxation on the dividend (on either a residence or worldwide income basis) in the foreign country in which it actively conducts a securities business, and (3) the full amount of the foreign taxes to which the exception applies must be creditable under the foreign country's tax system. A securities dealer for purposes of the exception is an entity which (1) is engaged in the active conduct of a securities business in a foreign country and (2) is registered as a securities broker or dealer under the Securities Exchange Act of 1934 or is licensed or authorized to conduct securities activities in such foreign country and subject to *bona fide* regulation by the securities regulatory authority of the foreign country. The Congress intended that the requirements of active conduct of a securities business by a securities dealer and of registration or licensing under U.S. or foreign law would be interpreted in the manner provided in the regulations proposed under section 1296(b)(3) (as in effect prior to the enactment of the Act). See Prop. Treas. Reg. sec. 1.1296–6. Under the Act, the Secretary of the Treasury is granted authority to issue regulations appropriate to carry out the exception for securities dealers, including regulations to prevent abuse of the exception and to treat other taxes as qualifying for the exception. The Congress anticipated that this regulatory authority could be used to treat as qualifying for the exception internal withholding taxes imposed by a foreign country on persons that are taxed on a residence basis as a result of doing business in the foreign country.

If a taxpayer is denied foreign tax credits under the Act because the 16- or 46-day holding period requirement is not satisfied, the taxpayer would be entitled to a deduction for the foreign taxes for which the credit is disallowed. This deduction would be available even if the taxpayer claimed the foreign tax credit for other taxes in the same taxable year.

No inference is intended as to the treatment under prior law of tax-motivated transactions intended to transfer foreign tax credit benefits.

Effective Date

The provision is effective for dividends paid or accrued more than 30 days after the date of enactment. Where a dividend is paid or accrued prior to the effective date, the provision does not apply to additional dividend amounts that are deemed to be paid with respect to the dividend under an applicable U.S. tax treaty.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $23 million in 1998, $48 million in 1999, $50 million in 2000, $53 million in 2001, $56 million in 2002, $58 million in 2003,

$61 million in 2004, $64 million in 2005, $68 million in 2006 and $71 million in 2007.

4. Limitation on treaty benefits for payments to hybrid entities (sec. 1054 of the Act and new sec. 894(c) of the Code)

Present and Prior Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) that are engaged in business in the United States are subject to U.S. tax on the income from such business in the same manner as a U.S. person. In addition, the United States imposes tax on certain types of U.S. source income, including interest, dividends and royalties, of foreign persons not engaged in business in the United States. Such tax is imposed on a gross basis and is collected through withholding. The statutory rate of this withholding tax is 30 percent. However, most U.S. income tax treaties provide for a reduction in the rate, or elimination, of this withholding tax. Treaties generally provide for different applicable withholding tax rates for different types of income. Moreover, the applicable withholding tax rates differ among treaties. The specific withholding tax rates pursuant to a treaty are the result of negotiations between the United States and the treaty partner.

The application of the withholding tax is more complicated in the case of income derived through an entity, such as a limited liability company, that is treated as a partnership for U.S. tax purposes but may be treated as a corporation for purposes of the tax laws of a treaty partner. The Treasury regulations include specific rules that apply in the case of income derived through an entity that is treated as a partnership for U.S. tax purposes. In the case of a payment of an item of U.S. source income to a U.S. partnership, the partnership is required to impose the withholding tax to the extent the item of income is includible in the distributive share of a partner who is a foreign person. Tax-avoidance opportunities could arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws).

Following the passage of the House bill and the Senate amendment, proposed and temporary regulations were issued addressing the application of the reduced rates of withholding tax provided under a treaty in cases involving a hybrid entity. Temp. Treas. Reg. sec. 1.894–1T.

Reasons for Change

The Congress was concerned about the potential tax-avoidance opportunities available for foreign persons that invest in the United States through hybrid entities. In particular, the Congress understood that the interaction of the tax laws and the applicable tax treaty could provide a business structuring opportunity that would allow Canadian corporations with U.S. subsidiaries to avoid both U.S. and Canadian income taxes with respect to those U.S. operations. The Congress believed that such tax-avoidance opportunities should be eliminated.

Explanation of Provision

The Act limits the availability of a reduced rate of withholding tax pursuant to an income tax treaty in order to prevent tax avoidance. Under the Act, a foreign person is not entitled to a reduced rate of withholding tax under a treaty with a foreign country on an item of income derived through an entity that is treated as a partnership (or is otherwise treated as fiscally transparent) for U.S. tax purposes if (1) such item is not treated for purposes of the taxation laws of such foreign country as an item of income of such person, (2) the foreign country does not impose tax on an actual distribution of such item of income from such entity to such person, and (3) the treaty itself does not contain a provision addressing the applicability of the treaty in the case of income derived through a partnership or other fiscally transparent entity. In this regard, the foreign country will be considered to impose tax on a distribution even though such tax may be reduced or eliminated by reason of deductions or credits otherwise available to the taxpayer. In addition, the Secretary of the Treasury is authorized to prescribe regulations to determine, in situations other than the situation specifically described in the statutory provision, the extent to which a taxpayer shall not be entitled to benefits under an income tax treaty of the United States with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for U.S. federal income tax purposes (or is otherwise treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.

The Act addresses a potential tax-avoidance opportunity for Canadian corporations with U.S. subsidiaries that arose because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of a U.S. limited liability company, which is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which could have been imposed at a reduced rate of 10 percent (rather than the full statutory rate of 30 percent) pursuant to the income tax treaty between the United States and Canada. Under the Act, withholding tax is imposed at the full statutory rate of 30 percent in such case. The Act would not apply if the U.S.-Canadian income tax treaty is amended to include a provision reaching a similar result. Moreover, the Act would not apply if Canada were to impose tax on the Canadian parent on dividends received from the U.S. limited liability company.

The Congress noted that on June 30, 1997 the Secretary issued proposed and temporary regulations addressing the availability of treaty benefits in cases involving hybrid entities. The Congress be-

lieved that these regulations are consistent with the provision in the Act. The Congress also believed that the provision in the Act and the temporary and proposed regulations are consistent with U.S. treaty obligations. Such provision and such regulations represent interpretations of U.S. treaties clarifying those situations involving hybrid entities in which taxpayers are entitled to treaty benefits and those situations in which they are not. The United States has recognized authority to implement its tax treaties so as to avoid abuses.

Effective Date

The provision was effective on the date of enactment (August 5, 1997). Accordingly, the provision applies to items of income received by the partnership (or other fiscally transparent entity) on or after August 5, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million per year in each of the years 1998 through 2007.

5. Interest on underpayments that are reduced by foreign tax credit carrybacks (sec. 1055 of the Act and secs. 6601 and 6611 of the Code)

Present and Prior Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the computation of interest on overpayments of tax, if an overpayment for a taxable year results from a foreign tax credit carryback from a subsequent taxable year, the overpayment is deemed not to arise prior to the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued (sec. 6611(g)). Accordingly, interest does not accrue on the overpayment prior to the filing date for the year of the carryback that effectively created such overpayment. In a decision that was subsequently overturned following enactment of the Taxpayer Relief Act of 1997 (the "Act"), the Court of Federal Claims held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that was eliminated by a foreign tax credit carryback from a subsequent taxable year, interest did not accrue on the underpayment that was eliminated by the foreign tax credit carryback. *Fluor Corp.* v. *United States*, 35 Fed. Cl. 520 (1996), *rev'd*, No. 96–5130 (Fed. Cir. 1997). The Court of Appeals for the Federal Circuit held that interest continued to accrue on the underpayment of tax that was eliminated by the foreign tax credit carryback, and remanded

the case for determination of the date on which such interest ceased to accrue.

Reasons for Change

The Congress believed that the application of the interest rules in the case of a deficiency that is reduced or eliminated by a foreign tax credit carryback must be consistent with the application of the interest rules in the case of an overpayment that is created by a foreign tax credit carryback. The Congress believed that in such cases the deficiency cannot be considered to have been eliminated, and the overpayment cannot be considered to have been created, until the filing date for the taxable year in which the foreign tax credit carryback arises. Accordingly, interest should continue to accrue on the deficiency through such date. In addition, the Congress believed that it is appropriate to clarify the interest rules that apply in the case of a foreign tax credit carryback that is itself triggered by another carryback from a subsequent year.

Explanation of Provision

Under the Act, if an underpayment for a taxable year is reduced or eliminated by a foreign tax credit carryback from a subsequent taxable year, such carryback does not affect the computation of interest on the underpayment for the period ending with the filing date for such subsequent taxable year in which the foreign taxes were paid or accrued. The Act also clarifies the application of the interest rules of both section 6601 and section 6611 in the case of a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback; in such a case, a deficiency is not considered to have been reduced, and an overpayment is not considered to have been created, until the filing date for the subsequent year in which the loss carryback arose. No inference is intended regarding the computation of interest under prior law in the case of a foreign tax credit carryback (including a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback).

Effective Date

The provision is effective for foreign taxes actually paid or accrued in taxable years beginning after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $8 million in 1998, $10 million in 1999, $2 million in 2000, and $1 million per year in each of 2001 through 2007.

6. Determination of period of limitations relating to foreign tax credits (sec. 1056 of the Act and sec. 6511(d) of the Code)

Present and Prior Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the period of limitations on filing claims for credit or refund, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is ten years from the filing date for the taxable year with respect to which the claim is made. The Internal Revenue Service has taken the position that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried) (Rev. Rul. 84–125, 1984–2 C.B. 125). However, the court in *Ampex Corp*. v. *United States*, 620 F.2d 853 (Ct. Cl.1980), held that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year to which the foreign tax credits are carried (and not the year in which the foreign taxes were paid or accrued).

Reasons for Change

The Congress believed that it is appropriate to identify clearly the date on which the ten-year period of limitations for claims with respect to foreign tax credits begins.

Explanation of Provision

Under the Act, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried). No inference is intended regarding the determination of such limitations period under prior law.

Effective Date

The provision is effective for foreign taxes paid or accrued in taxable years beginning after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1998, $2 million in 1999, and $1 million per year in each of 2000 through 2007.

7. Repeal special exception to foreign tax credit limitation for alternative minimum tax purposes (sec. 1057 of the Act and sec. 59 of the Code)

Present and Prior Law

Present law imposes a minimum tax on a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount.

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90 percent of the amount determined without these items.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") provided a special exception to the limitation on the use of the foreign tax credit against the tentative minimum tax. In order to qualify for this exception, a corporation must have met four requirements. First, more than 50 percent of both the voting power and value of the stock of the corporation must have been owned by U.S. persons who were not members of an affiliated group which included such corporation. Second, all of the activities of the corporation must have been conducted in one foreign country with which the United States had an income tax treaty in effect and such treaty must have provided for the exchange of information between such country and the United States. Third, the corporation generally must have distributed to its shareholders all current earnings and profits (except for certain amounts utilized for normal maintenance or capital expenditures related to its existing business). Fourth, all of such distributions which were received by U.S. persons must have been utilized by such persons in a U.S. trade or business. This exception applied to taxable years beginning after March 31, 1990 (with a proration rule effective for certain taxable years which included March 31, 1990).

Reasons for Change

The Congress believed that all taxpayers should be treated the same with respect to the foreign tax credit limitation of the alternative minimum tax.

Explanation of Provision

The Act repeals the special exception provided in the 1989 Act regarding the use of foreign tax credits for purposes of the alternative minimum tax.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (i.e., after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in 1998, $5 million in 1999, $5 million in

2000, $5 million in 2001, $5 million in 2002, $5 million in 2003, $5 million in 2004, $5 million in 2005, $5 million in 2006, and $5 million in 2007.

G. Partnership Provisions

1. Allocation of basis of properties distributed to a partner by a partnership (sec. 1061 of the 1997 Act and sec. 732(c) of the Code)

Present and Prior Law

In general

The partnership provisions generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[260] Rules are provided for determining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

[260] Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, allocation rules are provided for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Prior law provided for allocation in proportion to the partnership's adjusted basis. The rule allocated basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership (sec. 732(c)).[261] Under this allocation rule, in the case of a liquidating distribution, the distributee partner was able to have a basis in the distributed property that exceeded the partnership's basis in the property.

Reasons for Change

The prior-law rule providing that distributee partners allocate basis in proportion to the partnership's adjusted basis in the distributed property has given rise to problems in application.[262] The Congress was concerned that the prior-law rule permitted basis shifting transactions in which basis is allocated so as to increase basis artificially, giving rise to inflated depreciation deductions or artificially large losses, for example. The Congress believed that these problems would be significantly reduced by taking into account the fair market value of property distributed by a partnership for purposes of allocating basis in the hands of the distributee partner.

Explanation of Provision

The provision modifies the basis allocation rules for distributee partners. It allocates a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under present law). If the basis to be allocated is less than the sum of the adjusted bases of the properties in the

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[261] A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732–1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

[262] "The failure of these rules to take fair market value into account puts a high premium on tax planning in connection with in-kind liquidating distributions. Allocation of the portion of the basis in excess of the partnerships basis in the distributed assets according to their relative market values would be a conceptually sound approach, and would eliminate the strange results and manipulation possibilities . . ." W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partnerships and Partners* (3rd ed. 1997), sec. 19.06.

hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated as described below for adjustments that are decreases.

Under the provision, to the extent of any basis not allocated under the above rules, basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. For example, assume that a partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10. Under the provision, basis is first allocated to asset A in the amount of 5 and to asset B in the amount of 10 (their adjusted bases to the partnership). The remaining basis adjustment is an increase totaling 40 (the partner's 55 basis minus the partnership's total basis in distributed assets of 15). Basis is then allocated to asset A in the amount of 35, its unrealized appreciation, with no allocation to asset B attributable to unrealized appreciation because its fair market value equals the partnership's adjusted basis. The remaining basis adjustment of 5 is allocated in the ratio of the assets' fair market values, i.e., 4 to asset A (for a total basis of 44) and 1 to asset B (for a total basis of 11).

If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made). A remaining basis adjustment that is a decrease arises under the provision when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties. For example, assume that a partnership with two assets, C and D, distributes them both in liquidation to a partner whose basis in its partnership interest is 20. Neither asset consists of inventory or unrealized receivables. Asset C has a basis to the partnership of 15 and a fair market value of 15, and asset D has a basis to the partnership of 15 and a fair market value of 5. Under the provision, basis is first allocated to the extent of the partnership's basis in each distributed property, or 15 to each distributed property, for a total of 30. Because the partner's basis in its interest is only 20, a downward adjustment of 10 (30 minus 20) is required. The entire amount of the 10 downward adjustment is allocated to the property D, reducing its basis to 5. Thus, the basis of property C is 15 in the hands of the distributee partner, and the basis of property D is 5 in the hands of the distributee partner.

Effective Date

The provision applies to partnership distributions after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $26 million in 1998, $52 million in 1999, $55 million in 2000, $57 million in 2001, $59 million in 2002, $61 million in 2003, $64 million in 2004, $66 million in 2005, $69 million in 2006, and $72 million in 2007.

2. Treatment of inventory items of a partnership (sec. 1062 of the 1997 Act and sec. 751 of the Code)

Present and Prior Law

Under prior law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has substantially appreciated, is treated as an amount realized from the sale or exchange of property that is not a capital asset (sec. 751(a)).

Present and prior law provide a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution (sec. 751(b)).

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120 percent of adjusted basis of the inventory to the partnership (sec. 751(d)(1)(A)). In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory (sec. 751(d)(1)(B)).

Reasons for Change

The substantial appreciation requirement with respect to inventory of a partnership has been criticized as ineffective at properly treating income attributable to inventory as ordinary income under the section 751 rules for partnerships with profit margins below 20 percent.[263] Because the Congress believed that income attributable to inventory should be treated as ordinary income, the Act repeals

[263] The 1984 ALI study on partnership rules referred to the substantial appreciation requirement as subject to manipulation and tax planning (American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners,* (R. Cohen, reporter, 1984), 26. In 1993 the definition of substantially appreciated inventory was modified, and the present-law test relating to a principal purpose of avoidance was added (Omnibus Budget Reconciliation Act of 1993, P.L. 103–66, sec. 13206(e)(1)). Nevertheless, the substantial appreciation requirement is still criticized as ineffective (W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partners and Partnerships,* (3rd ed. 1997) sec. 16.04[2]).

the substantial appreciation requirement with respect to inventory, in the case of partnership sales or exchanges.

Explanation of Provision

The Act eliminates the requirement that inventory be substantially appreciated in order to give rise to ordinary income in the case of sales or exchanges of partnership interests under section 751(a) of the Code, but not in the case of distributions under section 751(b) of the Code. Thus, present law is retained with respect to distributions governed by section 751(b). This conforms the treatment of inventory to the treatment of unrealized receivables under the rules relating to sales or exchanges of partnership interests.

Effective Date

The provision is effective for sales, exchanges, and distributions after the date of enactment (August 5, 1997), except that the provision does not apply to any sale or exchange pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before such sale or exchange.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $30 million in 1998, $66 million in 1999, $69 million in 2000, $73 million in 2001, $77 million in 2002, $80 million in 2003, $84 million in 2004, $89 million in 2005, $93 million in 2006, and $98 million in 2007.

3. Treatment of appreciated property contributed to a partnership (sec. 1063 of the 1997 Act and secs. 704(c)(1)(B) and 737 of the Code)

Present and Prior Law

Under present law, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest ("book/tax differential"). Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (sec. 704(c)(1)(A)).

If the property is subsequently distributed to another partner within 5 years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution (sec. 704(c)(1)(B)). Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partner-

ship is made within 5 years after the contribution of the appreciated property (sec. 737).

Reasons for Change

The Congress was concerned that the inconsistency in treatment of partnership sales and partnership distributions of property contributed by partners makes it possible for partners to circumvent the rule requiring pre-contribution gain on contributed property to be allocated to the contributing partner. In order to limit the inconsistency and to reduce opportunities for circumventing this rule, the Congress believed that the contributing partner should recognize pre-contribution gain when the contributed property is distributed to another partner, or the partnership distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, within 7 years after the contribution of the appreciated property.

Explanation of Provision

The Act extends to 7 years the period in which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the provision, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, if the distribution occurs within 7 years after the contribution to the partnership.

Effective Date

The provision is effective for property contributed to a partnership after June 8, 1997, except that the provision does not apply to any property contributed to a partnership pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before such contribution, if the contract provides for the contribution of a fixed amount of property.

Revenue Effect

The provision is estimated neither to increase nor reduce Federal fiscal year budget receipts in 1998, 1999, 2000, and 2001, and to increase Federal fiscal year budget receipts by $2 million in 2002, $10 million in 2003, $11 million in 2004, $11 million in 2005, $12 million in 2006, and $12 million in 2007.

H. Pension and Employee Benefit Provisions

1. Cashout of certain accrued benefits (sec. 1071 of the Act and sec. 411(a)(11) of the Code)

Present and Prior Law

Under present and prior law, in the case of an employee whose plan participation terminates, a qualified plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent, and, if applica-

ble, the consent of the participant's spouse) if the present value of the benefit does not exceed a specified dollar amount. Under prior law, this dollar amount was $3,500. Under present and prior law, if a benefit is cashed out under this rule and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee "buys back" the benefit. If the present value determined at the time of a distribution to the participant exceeds the dollar limit, then the present value at any subsequent time is deemed to exceed the dollar limit.

Generally, a cash-out distribution from a qualified plan to a plan participant can be rolled over, tax free, to an IRA or to another qualified plan.

Reasons for Change

The Congress believed that the limit on involuntary cash-outs should be raised to $5,000 in recognition of the effects of inflation and the value of small benefits payable under a qualified pension plan.

Explanation of Provision

The Act increases the limit on involuntary cash-outs to $5,000 from $3,500 and permits plan amendments to increase the cashout limit to up to $5,000 without violating the anti-cutback rules (sec. 411(d)(6)).[264] All other rules applicable to cash-outs remain unchanged. For example, if, at the time of a distribution the present value of a participant's benefit exceeds $5,000, the benefit may not be involuntarily cashed out even if the actual value of the benefit falls below $5,000. Similarly, benefits of terminated vested participants can be cashed out, as long as a cashout would have been permitted under prior law if $5,000 were substituted for $3,500.

Effective Date

The provision is effective for plan years beginning after the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1997, $2 million in 1998, $6 million in 1999, $7 million in 2000, 2001 and 2002, $8 million in 2003 and 2004, $9 million in 2005 and 2006, and $10 million in 2007.

2. Election to receive taxable cash compensation in lieu of nontaxable parking benefits (sec. 1072 of the Act and sec. 132(f) of the Code)

Present and Prior Law

Under present and prior law, up to $170 per month of employer-provided parking is excludable from gross income. Under prior law,

[264] See section 1541 of the Act relating to adoption of plan amendments.

in order for the exclusion to apply, the parking had to be provided in addition to and not in lieu of any compensation otherwise payable to the employee. Under present and prior law, employer-provided parking cannot be provided as part of a cafeteria plan.

Reasons for Change

The Congress believed that it was appropriate to permit employees to choose between employer-provided parking and cash.

Explanation of Provision

The Act provides that no amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

Under this provision, parking may be provided through salary reduction. As under prior law, employer-provided parking cannot be provided as part of a cafeteria plan.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $3 million in 1998, $8 million in 1999, $11 million in 2000, $12 million in 2001, $12 million in 2002, $13 million in 2003, $14 million in 2004, $14 million in 2005, $15 million in 2006, and $16 million in 2007.

3. Repeal of excess distribution and excess retirement accumulation taxes (sec. 1073 of the Act and sec. 4980A of the Code)

Prior Law

Under prior law, a 15-percent excise tax was imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions were generally defined as the aggregate amount of retirement distributions from such plans during any calendar year in excess of $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The 15-percent excise tax did not apply to distributions received in 1997, 1998, and 1999.

An additional 15-percent estate tax was imposed on an individual's excess retirement accumulations. Excess retirement accumulations were generally defined as the balance in retirement plans in excess of the present value of a benefit that would not be subject to the 15-percent tax in excess distributions.

Reasons for Change

The excess distribution and retirement accumulation taxes were designed to limit the overall tax-deferred savings by individuals, as

well as to help ensure that tax-favored retirement vehicles were used primarily for retirement purposes. The Congress believed that the limits on contributions and benefits applicable to each type of vehicle are sufficient limits on tax-deferred savings. Additional penalties are unnecessary, and may also deter individuals from saving. The excess accumulation and distribution taxes also inappropriately penalize favorable investment returns.

Explanation of Provision

The Act repeals both the 15-percent excise tax on excess distributions and the 15-percent estate tax on excess retirement accumulations.

Effective Date

The provision repealing the excess distribution tax is effective with respect to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax is effective with respect to decedents dying after December 31, 1996.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $18 million in 1998, $19 million in 1999, $7 million in 2000, and increase such receipts by $18 million in 2001, $18 million in 2002, $16 million in 2003, $16 million in 2004, $14 million in 2005, $13 million in 2006, and $11 million in 2007.

4. Tax on prohibited transactions (sec. 1074 of the 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 10-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 is appropriate to increase the initial level prohibited transaction tax to discourage disqualified persons from engaging in such transactions.

Explanation of Provision

The Act increases the initial-level prohibited transaction tax from 10-percent to 15-percent.

Effective Date

The provision is effective with respect to prohibited transactions occurring after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in 1998, and $4 million per year during the period 1999 through 2007.

5. Basis recovery rules (sec. 1075 of the Act and sec. 72 of the Code)

Present and Prior Law

Under present and prior law, amounts received as an annuity under a tax-qualified pension plan generally are includible in income in the year received, except to the extent the amount received represents return of the recipient's investment in the contract (i.e., basis). The portion of each annuity payment that represents a return of basis generally is determined by a simplified method. Under this method, the portion of each annuity payment that is a return to basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a specified table, shown below. The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

Age of primary annuitant	*Number of payments*
55 or less	360
56–60	310
61–65	260
66–70	210
71 or more	160

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. 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. 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.

Reasons for Change

The table for determining anticipated payments does not differ depending on whether the annuity is payable in the form of a sin-

gle life annuity or a joint and survivor annuity. Applying the table for single life annuities to joint and survivor annuities understates the expected payments under a joint and survivor annuity.

Explanation of Provision

Under the Act, the prior-law table would apply to benefits based on the life of one annuitant. A separate table applies to benefits based on the life of more than one annuitant, as follows:

Combined age of annuitants	*Number of payments*
110 or less	410
111–120	360
121–130	310
131–140	260
141 and over	210

The new table applies to benefits based on the life of more than one annutitant, even if the amount of the annuity varies by annuitant. Thus, for example, the new table applies to a 50-percent joint and survivor annuity. The new table does not apply to an annuity paid on a single life merely because it has additional features, e.g., a term certain.

Effective Date

The provision is effective with respect to annuity starting dates beginning after December 31, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1998, $3 million in 1999, $6 million in 2000, $9 million in 2001, $11 million in 2002, $15 million in 2003, $18 million in 2004, $21 million in 2005, $24 million in 2006, and $27 million in 2007.

I. Other Revenue-Increase Provisions

1. Phase out suspense accounts for certain large farm corporations (sec. 1081 of the Act and sec. 447 of the Code)

Present and Prior Law

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as

a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year declined to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account was required to be included in gross income.

Reasons for Change

The Congress believed that an accrual method of accounting more accurately measures the economic income of a corporation than does the cash receipts and disbursements method and that changes from one method of accounting to another should be taken into account under section 481. However, the Congress believed that it may be appropriate for a family farm corporation to retain the use of the cash method of accounting until such corporation reaches a certain size. At that time, the corporation should be subject to tax accounting rules to which other corporations are subject. In addition, the Congress believed that the present-law suspense account provision applicable to large family farm corporations may effectively provide an exclusion for, rather than a deferral of, amounts otherwise properly taken into account under section 481 upon the required change in the method of accounting for such corporations. However, the Congress recognized that requiring the recognition of previously established suspense accounts may impose liquidity concerns upon some farm corporations. Thus, the Congress provided an extended period over which existing suspense accounts must be restored to income and provided further deferral where the corporation has insufficient income for the year.

Explanation of Provision

The Act repeals the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the Act, any family farm corporation required to change to an accrual method of accounting

would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

In addition, any taxpayer with an existing suspense account is required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the requirement to restore such accounts more rapidly when the corporation ceases to be a qualified family farm corporation. The amount required to be restored to income for a taxable year pursuant to the 20-year spread period shall not exceed the net operating loss of the corporation for the year (in the case of a corporation with a net operating loss) or 50 percent of the net income of the taxpayer for the year (for corporations with taxable income). For this purpose, a net operating loss or taxable income is determined without regard to the amount restored to income under the Act. Any reduction in the amount required to be restored to income is taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period. Amounts that extend beyond the 20-year period remain subject to the net operating loss and 50-percent-of-taxable income rules. The net operating loss and 50-percent-of-taxable income rules do not apply to restorations of suspense accounts that are required when the corporation ceases to be a qualified family farm corporation. In the case of a family farm corporation that elects to be an S corporation for a taxable year, the net operating loss and 50 percent of taxable income limitations shall be determined by taking into account all the items of income, gain, deduction and loss of the corporation, whether or not such items are separately stated under section 1366.

Finally, the Act repealed the present-law requirement to accelerate the recovery of suspense accounts when the gross receipts of the taxpayer diminishes.

Effective Date

The provision is effective for taxable years ending after June 8, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $29 million in 1998, $33 million in 1999, $35 million in 2000, $36 million in 2001, $37 million in 2002, $39 million in 2003, $40 million in 2004, $41 million in 2005, $43 million in 2006, and $44 million in 2007.

2. Modify net operating loss carryback and carryforward rules (sec. 1082 of the Act and sec. 172 of the Code)

Present and Prior Law

Under prior law, the net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) could be carried back three years and carried forward 15 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special

rules apply to real estate investment trusts ("REITs") (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Reasons for Change

The Congress recognized that while Federal income tax reporting requires a taxpayer to report income and file returns based on a 12-month period, the natural business cycle of a taxpayer may exceed 12 months. However, the Congress believed that allowing a two-year carryback of NOLs is sufficient to account for these business cycles, particularly since (1) many deductions allowed for tax purposes relate to future, rather than past, income streams and (2) certain deductions that do relate to past income streams are granted special, longer carryback periods under present law (which are retained by the Act). In order to compensate for the shortening of the carryback period, the Act extends the NOL carryforward period to 20 years.

Explanation of Provision

The Act limits the NOL carryback period to two years and extends the NOL carryforward period to 20 years. The Act does not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses.

The Act does not apply to NOLs arising from casualty losses of individual taxpayers. In addition, the Act does not apply to NOLs attributable to losses incurred in Presidentially declared disaster areas by taxpayers engaged in a farming business or a small business. For this purpose, a "small business" means any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under sec. 448(c)) of which are $5 million or less, and a "farming business" is defined as in section 263A(e)(4).

Effective Date

The provision is effective for NOLs for taxable years beginning after the date of enactment (i.e., after August 5, 1997). The provision does not apply to NOLs carried forward from prior taxable years.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $42 million in 1998, $303 million in 1999, $361 million in 2000, $256 million in 2001, $179 million in 2002, $136 million in 2003, $112 million in 2004, $100 million in 2005, $93 million in 2006, and $90 million in 2007.

3. Modify general business credit carryback and carryforward rules (sec. 1083 of the Act and sec. 38 of the Code)

Present and Prior Law

A qualified taxpayer is allowed to claim the rehabilitation credit, the energy credit, the reforestation credit, the work opportunity credit, the alcohol fuels credit, the research credit, the low-income housing credit, the enhanced oil recovery credit, the disabled access credit, the renewable electricity production credit, the empowerment zone employment credit, the Indian employment credit, the employer social security credit, and the orphan drug credit (collectively, known as the general business credit), subject to certain limitations based on tax liability for the year. Under prior law, unused general business credits generally could be carried back three years and carried forward 15 years to offset tax liability of such years, subject to the same limitations.

Explanation of Provision

The Act limits the carryback period for the general business credit to one year and extends the carryforward period to 20 years.

Effective Date

The provision is effective for credits arising in taxable years beginning after December 31, 1997. The provision does not apply to credits carried forward from prior taxable years.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $182 million in 1998, $300 million in 1999, and $81 million in 2000; to decrease Federal fiscal year budget receipts by $60 million in 2001, $32 million in 2002, and $9 million in 2003; and to increase Federal fiscal year budget receipts by $5 million in 2004, $15 million in 2005, $21 million in 2006, and $25 million in 2007.

4. Expand the limitations on deductibility of interest and premiums with respect to life insurance, endowment and annuity contracts (sec. 1084 of the Act and sec. 264 of the Code)

Present and Prior Law

Exclusion of inside buildup and amounts received by reason of death

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[265] Further, an exclusion from Federal income tax is pro-

[265] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the 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

Continued

vided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)).

Premium deduction limitation

Under prior law, no deduction was permitted for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy (sec. 264(a)(1)).

Interest deduction disallowance with respect to life insurance

Generally, no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual (the "COLI" rules). Under prior law, this limitation applied with respect to an individual who is or was (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.

This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average—Monthly Average Corporates applies in the case of such contracts.[266]

An exception to this interest disallowance rule is provided 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. For determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a 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.

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to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, 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 59½ 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). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

[266] In the case of contracts purchased after June 20, 1986, phase-in generally apply with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply.

The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.[267]

Interest deduction limitation with respect to tax-exempt interest income

No deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax (sec. 265(a)(2)). In addition, in the case a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt interest (sec. 265(b)). The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets (sec. 265(b)(2)).[268]

Reasons for Change

The Congress understood that, under applicable State laws, the holder of a life insurance policy generally is required to have an insurable interest in the life of the insured individual only when the policyholder purchases the life insurance policy. The Congress understood that under State laws relating to insurable interests, a taxpayer generally has an insurable interest in the lives of its debtors. Further, rules governing permitted investments of financial institutions may allow the institutions to acquire cash value life insurance covering the lives of debtors, as well as the lives of individuals with other relationships to the taxpayer such as shareholders, employees or officers. In addition, insurable interest laws in many States have been expanded in recent years, and States could decide in the future to expand further the range of persons in whom a taxpayer has an insurable interest.

For example, a business could purchase cash value life insurance on the lives of its debtors, and increase the investment in these contracts as the debt diminishes and even after the debt is repaid. If a mortgage lender can (under applicable State law and banking regulations) buy a cash value life insurance policy on the lives of mortgage borrowers, the lender may be able to deduct premiums or interest on debt with respect to such a contract, if no other deduction disallowance rule or principle of tax law applies to limit the deductions. The premiums or interest could be deductible even after the individual's mortgage loan is sold to another lender or to

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[267] Since 1942, a limitation has applied to the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)). For this purpose, a contract is treated as a single premium contract if (1) substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Further, under a limitation added in 1964, 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 (sec. 264(a)(3)). 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 debts (the "4-out-of-7 rule") (sec. 264(c)(1)). In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

[268] Special rules apply for certain tax-exempt obligations of small issuers (sec. 265(b)(3)).

a mortgage pool. If the loan were sold to a second lender, the second lender might also be able to buy a cash value life insurance contract on the life of the same borrower, and to deduct premiums or interest with respect to that contract. The Act addresses this issue by providing that no deduction is allowed for premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract, and by providing that no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, or an endowment or annuity contract, covering the life of any individual.

In addition, the Congress understood that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts.[269] The Congress believed that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the Act provides that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.

Explanation of Provision

Expansion of premium deduction limitation to individuals in whom taxpayer has an insurable interest

Under the provision, the prior-law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

The premium deduction limitation does not apply to premiums with respect to any annuity contract described in section 72(s)(5) (relating to certain qualified pension plans, certain retirement annuities, individual retirement annuities, and qualified funding assets), nor to premiums with respect to any annuity to which section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person).

Expansion of interest disallowance to individuals in whom taxpayer has insurable interest

Under the provision, no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract

[269] See "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post,* p. E3, February 8, 1997; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal,* p. C1, April 22, 1997.

is first issued, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

The Act specifies the treatment of certain interest to which the provision providing for expansion of interest disallowance to individuals in whom taxpayer has insurable interest otherwise would apply. The Act provides that in the case of a transfer for valuable consideration of a life insurance contract or any interest therein described in section 101(a)(2), the amount of the death benefit excluded from gross income under section 101(a) may not exceed an amount equal to the sum of the actual value of the consideration, premiums, interest disallowed as a deduction under new section 264(a)(4), and other amounts subsequently paid by the transferee. Thus, under the provision, in the case of the transfer for value of a life insurance contract, the interest with respect to the contract that otherwise would be disallowed under new section 264(a)(4) is capitalized, reducing the amount included in income by the transferee upon receipt by the transferee of the amounts paid by reason of the death of the insured.

Pro rata disallowance of interest on debt to fund life insurance

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer.

An exception is provided for any policy or contract[270] owned by an entity engaged in a trade or business, which covers one individual who (at the time first insured under the policy or contract) is (1) a 20-percent owner of the entity, or (2) an individual (who is not a 20-percent owner) who is an officer, director or employee of the trade or business. The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20-percent owner and the spouse of the 20-percent owner. A joint-life contract under which the sole insureds are a 20-percent owner and his or her spouse is the only type of policy or contract with more

[270] It was intended that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A of the Code, then coverage for each such insured individual is treated as a separate contract, for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20-percent owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of Code section 848(e)(2). No inference was intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law. A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

than one insured that comes within the exception. Thus, for example, if the insureds under a contract include an individual described in the exception (e.g., an employee, officer, director, or 20-percent owner) and any individual who is not described in the exception (e.g., a debtor of the entity), then the exception does not apply to the policy or contract. For purposes of this exception, a 20-percent owner has the same meaning as under present-law section 264(d)(4). In addition, the Act provides that the pro rata interest disallowance rule does not apply to any annuity contract to which section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person). The Act provides that any policy or contract that is not subject to the pro rata interest disallowance rule by reason of this exception (for 20-percent owners, their spouses, employees, officers and directors, and in the case of an annuity contract to which section 72(u) applies) is not taken into account in applying the ratio to determine the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the cash value of a contract.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract is treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value is treated as not exceeding the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the provision applies at the partnership or corporate level. The amount of the benefit is intended to take into account the amount payable to the business under the contract (e.g., as a death benefit) or pursuant to another agreement (e.g., under a split dollar agreement). The amount of the benefit is intended also to include any amount by which liabilities of the business would be reduced by payments under the policy or contract (e.g., when payments under the policy reduce the principal or interest on a liability owed to or by the business).

It is intended that the above exception under new section 264(f)(4)(A) (in the case of an employee, officer, director, or 20-percent owner) not be precluded from applying merely because the trade or business holds an economic interest in the policy but does not own an interest in the policy, for example, in the case of collateral assignment split dollar insurance.[271] This situation may arise if an individual employee owns a policy but the trade or business holds an interest in the policy by reason of being directly or indirectly a beneficiary under the policy pursuant to a collateral assignment split dollar arrangement. No inference is intended as to the treatment under present law of any other aspect of the arrangement (including, without limitation, the tax treatment of the

[271] A technical correction may be needed so that the statute reflects this intent.

individual or the trade or business with respect to the actual or constructive transfer of funds to the individual to pay premiums).

The issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report such information as is necessary to carry out this rule. The required reporting to the Treasury Secretary is an information return (within the meaning of sec. 6724(d)(1)), and any reporting required to be made by any other person is a payee statement (within the meaning of sec. 6724(d)(2)[272]). The Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form). This statutory reporting requirement does not supersede the authority of the Treasury Secretary under section 6001 of the Code to require reporting necessary to apply the premium or interest deduction limitations of the Act, for example, reporting by businesses that own life insurance, endowment or annuity contracts.

If interest expense is disallowed under other provisions of section 264 (limiting interest deductions with respect to life insurance policies or endowment or annuity contracts) or under section 265 (relating to tax-exempt interest), then the disallowed interest expense is not taken into account under this provision, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The provision is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property (sec. 263A).

An aggregation rule is provided, treating related persons as one for purposes of the provision. This aggregation rule is intended to prevent taxpayers from avoiding the pro rata interest limitation by owning life insurance, endowment or annuity contracts, while incurring interest expense through a related person.

The provision does not apply to any insurance company subject to tax under subchapter L of the Code. Rather, the rules reducing certain deductions for losses incurred, in the case of property and casualty companies, and reducing reserve deductions or dividends received deductions of life insurance companies, are modified to take into account the increase in cash values of life insurance policies or annuity or endowment contracts held by insurance companies. For purposes of those rules, an increase in the policy cash value for any policy or contract is (1) the amount of the increase in the adjusted cash value, reduced by (2) the gross premiums received with respect to the policy or contract during the taxable year, and increased by (3) distributions under the policy or contract to which section 72(e) apply (other than amounts includable in the policyholder's gross income). For this purpose, the adjusted cash value means the cash surrender value of the policy or contract, increased by (1) commissions payable with respect to the policy or contract for the taxable year, and (2) asset management fees, surrender and mortality charges, and any other fees or charges, specified in regulations, which are imposed (or would be imposed if the

[272] A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

policy or contract were surrendered or canceled) with respect to the policy or contract for the taxable year.

Effective Date

The provisions apply with respect to contracts issued after June 8, 1997.

To the extent of additional covered lives after June 8, 1997 under certain master contracts, the coverage of each additional insured individual is treated as a new contract. This treatment of additional covered lives applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract (because such coverage is treated as a separate contract for purposes of sections 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of section 848(e)(2)).[273]

For purposes of the effective date, a material increase in the death benefit or other material change in the contract causes the contract to be treated as a new contract. In the case of an increase in the death benefit of a contract that is converted to extended term insurance pursuant to nonforfeiture provisions, in a transaction to which section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") applies, the contract is not treated as a new contract. It was not intended that a new contract is required to be issued in connection with such a transaction, but rather, it was intended that the increase in the death benefit of the contract so converted in such a transaction not cause the contract to be treated as a new contract for purposes of this effective date.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $20 million in 1998, $53 million in 1999, $93 million in 2000, $140 million in 2001, $193 million in 2002, $247 million in 2003, $299 million in 2004, $349 million in 2005, $399 million in 2006, and $447 million in 2007.

5. Earned income credit compliance provisions (secs. 1085(a), (b) and (d) of the Act and sec. 32 of the Code)

Overview

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. 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

[273] This rule is consistent with the intended treatment of coverage of insured individuals under master contracts under the provision (as described above). A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

rate by the individual's[274] earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of the alternative minimum tax ("AMT") the taxpayer owes for the year. The credit is phased out above certain income levels.

For individuals with earned income (or 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 definition of AGI used for phasing out the earned income credit disregards 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 business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. Also, 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 $2,250. Disqualified income is the sum of: (1) interest (taxable and tax-exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income (if greater than zero) that is not self-employment income. The earned income amount, the phaseout amount and the disqualified income amount are indexed for inflation.

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1997, the parameters are given in the following table:

Present-Law Earned Income Credit Parameters

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	$9,140	$6,500	$4,340
Maximum credit	$3,656	$2,210	$332
Phaseout begins	$11,930	$11,930	$5,430
Phaseout rate (percent)	21.06	15.98	7.65
Phaseout ends	$29,290	$25,760	$9,770

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.

[274] 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.

a. Deny EIC eligibility for prior acts of recklessness or fraud (sec. 1085(a)(1) of Act and new sec. 32(k)(1) of the Code)

Present and Prior Law

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement (sec. 6662). Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud (sec. 6663).

Neither the accuracy-related penalty nor the fraud penalty is imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith with respect to that portion.

Reasons for Change

The Congress believed that taxpayers who fraudulently claim the EIC or recklessly or intentionally disregard EIC rules or regulations should be penalized for doing so.

Explanation of Provision

Under the Act, a taxpayer who fraudulently claims the earned income credit (EIC) is ineligible to claim the EIC for a subsequent period of 10 years. In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC for a subsequent period of two years. These sanctions are in addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations are made in a deficiency proceeding (which provides for judicial review).

Effective Date

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

Revenue Effect

The provisions relating to (a) the denial of EIC eligibility for prior acts of recklessness or fraud, (b) the recertification requirement when a taxpayer has been found eligible for the EIC in the past, and (c) the due diligence requirements for paid preparers are estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1998, $18 million in 1999, $25 million in 2000, $24 million in 2001, $21 million in 2002, $21 million in 2003, $21 million in 2004, $21 million in 2005, $21 million in 2006, and $21 million in 2007.

b. Recertification required when taxpayer found to be ineligible for EIC in past (sec. 1085(a)(1) of the Act and new sec. 32(k)(2) of the Code)

Present and Prior Law

If an individual fails to provide a correct TIN and claims the EIC, such omission is treated as a mathematical or clerical error. Also, if an individual who claims the EIC with respect to net earnings from self employment fails to pay the proper amount of self-employment tax on such net earnings, the failure is treated as a mathematical or clerical error for purposes of the amount of EIC claims. Generally, taxpayers have 60 days in which they can either provide a correct TIN or request that the IRS follow the current-law deficiency procedures. If a taxpayer fails to respond within this period, he or she must file an amended return with a correct TIN or clarify that any self-employment tax has been paid in order to obtain the EIC originally claimed.

The IRS must follow deficiency procedures when investigating other types of questionable EIC claims. Under these procedures, contact letters are first sent to the taxpayer. If the necessary information is not provided the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made and the EIC is denied.

Reasons for Change

The Congress believed that the requirement of additional information to determine EIC eligibility is prudent for taxpayers who have incorrectly claimed the EIC in the past.

Explanation of Provision

Under Act, a taxpayer who has been denied the EIC as a result of deficiency procedures is ineligible to claim the EIC in subsequent years unless evidence of eligibility for the credit is provided by the taxpayer. To demonstrate current eligibility, the taxpayer is required to meet evidentiary requirements established by the Secretary of the Treasury. Failure to provide this information when claiming the EIC is treated as a mathematical or clerical error. If a taxpayer is recertified as eligible for the credit, the taxpayer is not required to provide this information in the future unless the IRS again denies the EIC as a result of a deficiency procedure. Ineligibility for the EIC under the provision is subject to review by the courts.

Effective Date

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

Revenue Effect

The provisions relating to: (a) the denial of EIC eligibility for prior acts of recklessness or fraud, (b) the recertification requirement when a taxpayer has been found eligible for the EIC in the past, and (c) the due diligence requirements for paid preparers are estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1998, $18 million in 1999, $25 million in 2000, $24 million in 2001, $21 million in 2002, $21 million in 2003, $21 million in 2004, $21 million in 2005, $21 million in 2006, and $21 million in 2007.

c. Due diligence requirements for paid preparers (sec. 1085(a)(2) of the Act and new sec. 6695(g) of the Code)

Present and Prior Law

Several penalties apply in the case of an understatement of tax that is caused by an income tax return preparer. First, if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position and such position was not disclosed or was frivolous, then that return preparer is subject to a penalty of $250 with respect to that return or claim (sec. 6694(a)). The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith.

In addition, if any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of rules or regulations by an income tax return preparer, then the income tax return preparer is subject to a penalty of $1,000 with respect to that return or claim (sec. 6694(b)).

Also, a penalty for aiding and abetting the understatement of tax liability is imposed in cases where any person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result (sec. 6701).

Additional penalties are imposed on return preparers with respect to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy or list of the returns prepared, and (5) file a correct information return (sec. 6695). The penalty is $50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to $25,000.

Reasons for Change

The Congress believed that more thorough efforts by return preparers are important to improving EIC compliance.

Explanation of Provision

Under the Act, return preparers are required to fulfill certain due diligence requirements with respect to returns they prepare claiming the EIC. The penalty for failure to meet these requirements is $100. This penalty is in addition to any other penalty imposed under present law.

Effective Date

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

Revenue Effect

The provisions relating to: (a) the denial of EIC eligibility for prior acts of recklessness or fraud, (b) the recertification requirement when a taxpayer has been found eligible for the EIC in the past, and (c) the due diligence requirements for paid preparers are estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1998, $18 million in 1999, $25 million in 2000, $24 million in 2001, $21 million in 2002, $21 million in 2003, $21 million in 2004, $21 million in 2005, $21 million in 2006, and $21 million in 2007.

d. Modify the definition of AGI used to phase out the EIC (secs. 1085(b) and (d) of the Act and sec. 32(c)(5) of the Code)

Present Law

The EIC is phased out above certain income levels. For individuals with earned income (or 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 definition of AGI used for the phaseout of the earned income credit disregards 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 business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

Reasons for Change

The Congress believed it could 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 and disregards other components of ability-to-pay. Tax-exempt interest and nontaxable dis-

tributions from pensions, annuities and individual retirement arrangements increase individuals' ability-to-pay and reduce the need for a tax credit. The Congress also believed that denying more business losses would more closely conform the definition of modified AGI to real economic income.

Explanation of Provision

The Act modifies the definition of modified AGI used for phasing out the EIC by adding two items of nontaxable income and changing the percentage of certain losses disregarded. The two items added are: (1) tax-exempt interest, and (2) nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period). The Act also increases the disregarded amount of net business losses from 50 percent to 75 percent, computed separately with respect to sole proprietorships (other than farming), sole proprietorships in farming, and other businesses.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in 1998, $72 million in 1999, $75 million in 2000, $79 million in 2001, $85 million in 2002, $89 million in 2003, $92 million in 2004, $94 million in 2005, $99 million in 2006, and $102 million in 2007.[275]

6. Treatment of amounts received under the work requirements of the Personal Responsibility and Work Opportunity Act of 1996 (sec. 1085(c) of the Act and sec. 32(c)(2)(B) of the Code)

Present Law

Workfare payments

Generally under the Personal Responsibility and Work Opportunity Act of 1996, the receipt of certain government assistance payments is denied unless the recipient meets certain work requirements. The tax treatment of payments received with respect to these work requirements ("workfare payments") was not specified in that legislation.

Earned income credit

Certain eligible low-income workers are entitled to claim a refundable earned income 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 generally determined by multiplying the credit rate by the individual's earned income up to an earned income amount.

[275] This estimate includes outlay reduction of $254 million for 1997–2002 and $650 million for 1997–2007.

The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of the alternative minimum tax ("AMT") the taxpayer owes for the year. The credit is phased out above certain income levels. For individuals with earned income (or 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. For these purposes, both earned income and AGI are defined to include wages. There is no explicit provision whether workfare payments are wages for purposes of the earned income credit.

Reasons for Change

The Congress believed it inappropriate to provide the earned income credit for workfare payments.

Explanation of Provision

The Act provides that workfare payments are not wages for purposes of the earned income credit. There is no inference intended with respect to whether workfare payments otherwise qualify as wages for purposes of income and employment taxes or as wages for purposes of an employer's eligibility for the work opportunity tax credit and the welfare-to-work tax credit. Also, there is no inference intended with respect to whether workfare payments are wages for purposes of the earned income credit before enactment of this provision.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

7. Eligibility for income forecast method (sec. 1086 of the Act and secs. 167 and 168 of the Code)

Present and Prior Law

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. Acquired intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable 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 properly elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other appropriate 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 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 recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the "income forecast" method.

The income forecast method is considered to be a method of depreciation not expressed in a term of years. Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (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 income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games.[276] Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.[277]

Reasons for Change

Depreciation allowances attempt to measure the decline in the value of property due to wear, tear, and obsolescence and to match the cost recovery for the property with the income stream produced by the property. The Congress believed that the income forecast method of depreciation is, in theory, an appropriate method to match the recovery of cost of property with the income stream produced by the property. However, when compared to MACRS, the income forecast method involves significant complexities, including the determination of the income estimated to be generated by the property, the determination of the residual value of the property, and the application of the look-back method. Thus, the Congress believed that the availability of the income forecast method should be limited to instances where the economic depreciation of the

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[276] 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.

[277] See, *ABC Rentals of San Antonio* v. *Comm.,* 97 F.3d 392 (10th Cir., 1996), *pet. for rehg. filed* (Nov. 16, 1996) where the Tenth Circuit decision reversed the holding of *ABC Rentals of San Antonio* v. *Comm.,* 68 TCM 1362 (1994) and held that consumer durable property subject to short-term, "rent-to-own" leases were eligible for the income forecast method. For decisions supporting the Tax Court memorandum decision denying eligibility for certain tangible personal property, see *El Charro TV Rental* v. *Comm.,* 79 F.3d 1145 (5th Cir., 1996) (rent-to-own property not eligible) and *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).

property cannot be adequately reflected by the passage of time alone or where the income stream from the property is sufficiently unpredictable or uneven such that the application of another method of depreciation may result in the distortion of income. In addition, because the income forecast method is elective, the Congress was concerned about taxpayer selectivity.

Finally, the Congress provided a MACRS class life for consumer durables subject to rent-to-own contracts, in order to avoid future controversies with respect to the proper treatment of such property.

Explanation of Provision

The Act clarifies the types of property to which the income forecast method may be applied. Under the Act, the income forecast method is available to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. It is expected that the Secretary will exercise this authority such that the income forecast method will be available to property the economic depreciation of which cannot be adequately measured by the passage of time alone or to property the income from which is sufficiently unpredictable or uneven so as to result in the distortion of income. The mere fact that property is subject to a lease should not make the property eligible for the income forecast method. The income forecast method is not to be applicable to property to which section 197 applies.

In addition, consumer durables subject to rent-to-own contracts are provided a three-year recovery period and a four-year class life for MACRS purposes (and would not be eligible for the income forecast method). Such property generally is described in Rev. Proc. 95–38, 1995–2 C.B. 397. In addition, the special 3-year recovery period may apply to any property generally used in the home for personal, but not business, use. Congress understood that certain rent-to-own property, including computer and peripheral equipment, may be used in the home for either personal or business purposes, and the taxpayer may not be aware of how its customers may use the property. So as not to increase the administrative burdens of taxpayers, the Congress intended that if such dual-use property does not represent a significant portion of a taxpayer's leasing property and if such other leasing property predominantly is qualified rent-to-own property, then such dual-use property generally also would be qualified rent-to-own property. However, if such dual-use property represents a significant portion of the taxpayer's leasing property, the Congress intended that the burden of proof be placed on the taxpayer to show that such property is qualified rent-to-own property. Further, the definition of "rent-to-own contract" includes leases that provide for level regular periodic payments or decreasing regular periodic payments, where no payment is less than 40 percent of the largest payment.

Finally, the Congress clarified that the 3-year recovery period provided by the Act only applies to property subject to leases and no inference is intended as to whether any arrangement constitutes a lease for tax purposes.

Effective Date

The provision is effective for property placed in service after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $29 million in 1998, $41 million in 1999, $62 million in 2000, $78 million in 2001, $38 million in 2002, $27 million in 2003, $25 million in 2004, $17 million in 2005, $17 million in 2006, and $18 million in 2007.

8. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts (sec. 1087 of the 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 converted property within a specified replacement period of time. Pursuant to a provision of Public Law 104–7, subchapter C corporations (and certain partnerships with corporate partners) are 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 this related party rule provides that a taxpayer 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 replacement period.

Reasons for Change

The Congress believed that, except for de minimis cases, individuals should be subject to the same rules with respect to the acquisition of replacement property from a related person as are other taxpayers.

Explanation of Provision

The Act expands the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

The provision applies to involuntary conversions occurring after June 8, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1998, $4 million in 1999, $6 million in 2000, $8 million in 2001, $11 million in 2002, $13 million in 2003, $15 million in 2004, $17 million in 2005, $19 million in 2006, and $21 million in 2007.

9. Repeal of exception for certain sales by manufacturers to dealers (sec. 1088 of the Act and sec. 811(c) of the Tax Reform Act of 1986)

Present and Prior Law

In general, under present law, the installment method of accounting may not be used by dealers in personal property. Prior law provided an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer,[278] but only if the dealer was obligated to make payments of principal only when the dealer resold (or rented) the property, the manufacturer had the right to repurchase the property at a fixed (or ascertainable) price after no longer than a 9-month period following the sale to the dealer, and certain other conditions were met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualified for the exception must have equaled at least 50 percent of the total sales to dealers that gave rise to such receivables (the "50-percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not have been treated as failing to meet the 50-percent test before the second consecutive year in which the taxpayer did not actually meet the test. In addition, these requirements must have been met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date were treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

Reasons for Change

The Congress believed that the special exception that permitted certain dealers to use the installment method was no longer necessary or appropriate and the installment sale method of accounting should not be available to such dealers. Accordingly, the Act repeals that exception.

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[278] I.e., the sale of the property must be intended to be for resale or leasing by the dealer.

Explanation of Provision

The Act repeals the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

Effective Date

The provision is effective for taxable years beginning one year after the date of enactment (August 5, 1997). Any resulting adjustment from a required change in accounting will be includible ratably over the 4 taxable years beginning after that date.[279]

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $44 million in 1999, $97 million in 2000, $106 million in both 2001 and 2002, $64 million in 2003, $21 million in 2004, $22 million in 2005, $23 million in 2006, and $24 million in 2007.

10. Treatment of charitable remainder trusts (sec. 1089 of the Act and sec. 664 of the Code)

Present and Prior Law

In general

Sections 170(f), 2055(e)(2) and 2522(c)(2) of present law disallow a charitable deduction for income, estate or gift tax purposes, respectively, where the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, pooled income funds, farms, and personal residences; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) an undivided portion of the donor's entire interest in the property; and (4) a qualified conservation easement.

Charitable remainder annuity trusts and charitable remainder unitrusts

A charitable remainder annuity trust is a trust which is required to pay a fixed dollar amount, not less often than annually, of at least 5 percent of the initial value of the trust to a non-charity for the life of an individual or a period of years not to exceed 20 years, with the remainder passing to charity. A charitable remainder unitrust is a trust which generally is required to pay, at least annually, a fixed percentage of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or a period of years not to exceed 20 years, with the remainder passing to charity (sec. 664(d)).

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated first as ordinary income to the

[279] A technical correction is necessary to accomplish this result.

extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred; second, as capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; third, as other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and, fourth, as corpus (sec. 664(b)).

Distributions are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year. Treas. Reg. sec. 1.664–1(d)(4).

On April 18, 1997, the Treasury Department proposed regulations providing additional rules under sections 664 and 2702 to address the abuse described below and other perceived abuses involving distributions from charitable remainder trusts. One of those proposed rules would require that payment of any required annuity or unitrust amount by a charitable remainder trust (other than an "income only" unitrust) be made by the close of the trust's taxable year in which such payments are due. See Prop. Treas. Reg. secs. 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i).

Reasons for Change

The Congress was concerned that the interplay of the rules governing the timing of income from distributions from charitable remainder trusts (*i.e.,* Treas. Reg. sec. 1.664–1(d)(4) and the rules governing the character of distributions (*i.e.,* sec. 664(b)) created opportunities for abuse where the required annual payments are a large portion of the trust and realization of income and gain can be postponed until a year later than the accrual of such large payments. For example, some taxpayers have been creating charitable remainder unitrusts with a required annual payout of 80 percent of the trust's assets and then funding the trust with highly appreciated nondividend paying stock which the trust sells in a year subsequent to when the required distribution is includible in the beneficiary's income and using proceeds from that sale to pay the required distribution attributable to the prior year. Those taxpayers have treated the distribution of 80 percent of the trust's assets attributable to the trust's first required distribution as non-taxable distributions of corpus because the trust had not realized any income in its first taxable year. The Congress believed that such treatment is abusive and is inconsistent with the purpose of the charitable remainder trust rules. In order to limit this kind of abuse, the Act provides that a trust cannot be a charitable remainder trust if the required payout is greater than 50 percent of the initial fair market value of the trust's assets (in the case of a charitable remainder annuity trust) or 50 percent of the annual value of the trust's assets (in the case of a charitable remainder unitrust).

In addition, the Congress was concerned that certain charitable remainder trusts had been created primarily to obtain the tax benefit of the trust's exemption from income tax under section 664(c) and not to provide for charity. The Congress was aware that many

charitable remainder trusts have been created where the actuarial value of the charitable remainder interest at the time of creation is insignificant. The Congress believed that requiring that the actuarial value of the charitable remainder interest be at least 10 percent of any transfers to the trust will insure that any benefits from the creation of charitable remainder trusts be available only where there is a significant benefit to charity.

The Congress intended that the provision of the Act not limit or alter the validity of regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address this or other abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

Explanation of Provision

50-percent payout limitation

Under the Act, a trust cannot be a charitable remainder annuity trust if the annuity for any year is greater than 50 percent of the initial fair market value of the trust's assets or be a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. Any trust that fails this 50-percent rule will not be a charitable remainder trust whose taxation is governed under section 664, but will be treated as a complex trust and, accordingly, all its income will be taxed to its beneficiaries or to the trust.

10-percent minimum value of remainder interest

In addition, the Act requires that the value of the charitable remainder with respect to any transfer to a qualified charitable remainder annuity trust or charitable remainder unitrust be at least 10 percent of the net fair market value of such property transferred in trust on the date of the contribution to the trust. The 10-percent test is measured on each transfer to the charitable remainder trust and, consequently, a charitable remainder trust which meets the 10-percent test on the date of transfer will not subsequently fail to meet that test if interest rates have declined between the trust's creation and the death of a measuring life. Similarly, where a charitable remainder trust is created for the joint lives of two individuals with a remainder to charity, the trust will not cease to qualify as a charitable remainder trust because the value of the charitable remainder was less than 10 percent of the trust's assets at the first death of those two individuals.

The Act provided additional rules in order to provide relief for trusts that do not meet the 10-percent rule. First, where a transfer is made after July 28, 1997, to a charitable remainder trust that fails the 10-percent test, the trust is treated as meeting the 10-percent requirement if the governing instrument of the trust is changed by reformation, amendment, construction, or otherwise to meet such requirement by reducing the payout rate or duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement so long as the reformation is commenced within the period permitted for reformations of charitable remainder trusts under section 2055(e)(3). The statute of limitations applicable to a deficiency of any tax resulting from reforma-

tion of the trust does not expire before the date one year after the Treasury Department is notified that the trust has been reformed. In substance, this rule relaxes the requirements of section 2055(e)(3)(B) to the extent necessary for the reformation for the trust to meet the 10-percent requirement.

Second, a transfer to a trust will be treated as if the transfer never had been made where a court having jurisdiction over the trust subsequently declares the trust void (because, e.g., the application of the 10-percent rule frustrates the purposes for which the trust was created) and judicial proceedings to revoke the trust are commenced within the period permitted for reformations of charitable remainder trusts under section 2055(e)(3). Under this provision, the effect of "unwinding" the trust is that any transactions made by the trust with respect to the property transferred (e.g., income earned on the assets transferred to the trust and capital gains generated by the sales of the property transferred) would be income and capital gain of the donor (or the donor's estate if the trust was testamentary), and the donor (or the donor's estate if the trust was testamentary) would not be permitted a charitable deduction with respect to the transfer. The statute of limitations applicable to a deficiency of any tax resulting from "unwinding" the trust does not expire before the date one year after the Treasury Department is notified that the trust has been revoked.

Third, where an additional contribution is made after July 28, 1997, to a charitable remainder unitrust created before July 29, 1997, and that unitrust would not meet the 10-percent requirement with respect to the additional contribution, the Act provides that such additional contribution will be treated, under regulations to be issued by the Secretary of the Treasury, as if it had been made to a new trust that does not meet the 10-percent requirement, but which does not affect the status of the original unitrust as a charitable remainder trust.

Effective Date

50-percent payout limitation

The provision that requires that the payout rate of a qualified charitable remainder trust be not exceed 50 percent applies to transfers to a trust made after June 18, 1997.

10-percent minimum value of remainder interest

The requirement that the value of the charitable remainder with respect to any transfer to a qualified remainder trust be at least 10 percent of the fair market value of the assets transferred in trust applies to transfers to a trust made after July 28, 1997. However, the 10-percent requirement does not apply to a charitable remainder trust created by a testamentary instrument (e.g., a will or revocable trust) executed before July 29, 1997, if the instrument is not modified after that date and the settlor dies before January 1, 1999, or could not be modified after July 28, 1997, because the settlor was under a mental disability on that date (i.e., July 28, 1997) and all times thereafter.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $6 million per year for each of the years from 1997 through 2007.

11. Expanded SSA records for tax enforcement (secs. 1090(a)(1) and sec. 1090(b) of the Act and secs. 205(c)(2) and 454(e) of the Social Security Act)

Present Law

Under the Family Support Act of 1988, States must require each parent to furnish their social security number (SSN) for birth records. Parents can apply directly to the Social Security Administration (SSA) for an SSN for their child; or, in most states, they may apply for the child's SSN when obtaining a birth certificate. On an individual's SSN application, the SSA currently requires the mother's maiden name but not her SSN.

Reasons for Change

The Congress anticipates that the Internal Revenue Service (IRS) will use this information to identify questionable claims for the earned income credit, the dependent exemption, and other tax benefits, before tax refunds are paid out.

Explanation of Provision

Under the Act, the SSA is required to obtain social security numbers (SSNs) of both parents on minor children's applications for SSNs. Also, the SSA will provide this information to the IRS as part of the Data Master File ("DM–1 file").

Effective Date

The provision was generally effective on the date of enactment (August 5, 1997). The requirement that the SSA obtain SSNs of both parents on minor children's applications for SSNs, however, is effective for applications made 180 days after the date of enactment.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $10 million per year from 1999 through 2007.

12. Using Federal case registry of child support orders for tax enforcement purposes (secs. 1090(a)(2) and 1090(a)(3) of the Act and sec. 453(h) of the Social Security Act)

Present Law

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 mandated the creation of a Federal Case Registry of Child Support Orders (the FCR) by October 1, 1998. Although HHS has not yet issued final regulations, the FCR is required to include the names, and the State case identification numbers of individuals who are owed or who owe child support or for whom pa-

ternity is being established. It may also include the social security numbers (SSNs) of these individuals.

Reasons for Change

The Congress believed that the data collected by the State and local governments and incorporated into the FCR can be useful to the Internal Revenue Service (IRS). Therefore, the provision makes this information available to the IRS to enforce the tax law.

Explanation of Provision

Not later than October 1, 1998, the Secretary of the Treasury will have access to the Federal Case Registry of Child Support Orders. Also, by October 1, 1999, the data elements on the State Case Registry will include the SSNs of children covered by cases in the Registry, and the States will provide the SSNs of these children to the FCR.

Effective Date

The provision is effective on October 1, 1998.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $10 million in 2001, $20 million in 2002, $30 million in 2003, $40 million in 2004, $60 million in 2005, $85 million in 2006, and $105 million in 2007.

13. Modification of estimated tax safe harbors (sec. 1091 of the Act and sec. 6654 of the Code)

Present and Prior Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. Under prior law, the 100 percent of last year's liability safe harbor was modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year. If a married individual filed a separate return for the year for which an estimated tax installment payment was due, the $150,000 amount became $75,000.

Explanation of Provision

The Act changes the 110 percent of last year's liability safe harbor to be a 100 percent of last year's liability safe harbor for taxable years beginning in 1998, a 105 percent of last year's liability safe harbor for taxable years beginning in 1999, 2000, and 2001, and a 112 percent of last year's liability safe harbor for taxable years beginning in 2002.

In addition, no estimated tax penalties will be imposed under section 6654 or section 6655 (relating to estimated tax payments of individuals and corporations, respectively) for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to an underpayment to the extent the underpayment is created or increased by a provision of the Act.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $7,400 million in 1998, increase fiscal year budget receipts by $4,000 million in 1999, increase fiscal year budget receipts by $4,400 million in 2002, and reduce fiscal year budget receipts by $1,000 million in 2003.

TITLE XI. FOREIGN TAX PROVISIONS

A. General Provisions

1. Simplify foreign tax credit limitation for individuals (sec. 1101 of the Act and sec. 904 of the Code)

Present and Prior Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, under prior law, this required the filing of IRS Form 1116.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments. Taxable income of this type ordinarily is includible in the single foreign tax credit limitation category for passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in one of several other separate limitation categories (e.g., high withholding tax interest income or general limitation income). For this reason, any taxpayer with foreign source gross income was required to provide sufficient detail on IRS Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, was allocated to the correct limitation category.

Reasons for Change

The Congress believed that a significant number of individuals are entitled to credit relatively small amounts of foreign tax imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, the applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, exempting these taxpayers from the foreign tax credit limitation rules significantly reduces the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, the Congress believed that this exemption should be limited to those cases where the taxpayer receives a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The Act allows individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, an exemption from the foreign tax credit limitation rules. (The Congress intended that an individual electing this exemption will not be required to file IRS Form 1116 in order to obtain the benefit of the foreign tax credit.) An individual making this election is not entitled to any carryover of excess foreign taxes to or from a taxable year to which the election applies.

For purposes of this election, passive income generally is defined to include all types of income that is foreign personal holding company income under the subpart F rules, plus income inclusions

from foreign personal holding companies and passive foreign investment companies, provided that the income is shown on a payee statement furnished to the individual. For purposes of this election, creditable foreign taxes include only foreign taxes that are shown on a payee statement furnished to the individual.

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 less than $1 million in 1998 and by $1 million per year in each of the years 1999 through 2007.

2. Simplify translation of foreign taxes (sec. 1102 of the Act and secs. 905(c) and 986 of the Code)

Present and Prior Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession. This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation.

Redetermination of foreign taxes

Under prior law, for taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies were translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. If a difference existed between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arose. A foreign tax redetermination could occur in the case of a refund of foreign taxes. A foreign tax redetermination also could arise because the amount of foreign currency units actually paid differed from the amount of foreign currency units accrued. In addition, a redetermination could arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person required notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. The Treasury regulations provide exceptions to this rule for de minimis cases. In the case of a redetermination of foreign taxes that qualify for the indirect (or "deemed-paid") foreign tax credit under sections

902 and 960, the Treasury regulations generally require taxpayers to make appropriate adjustments to the payor foreign corporation's pools of earnings and profits and foreign taxes.

Reasons for Change

The Congress believed that the administrative burdens associated with the foreign tax credit can be reduced significantly by permitting foreign taxes to be translated using reasonably accurate average translation rates for the period in which the tax payments are made. This approach will reduce, sometimes substantially, the number of translation calculations that are required to be made. In addition, the Congress believed that taxpayers that are on the accrual basis of accounting for purposes of determining creditable foreign taxes should be permitted to translate those taxes into U.S. dollar amounts in the year to which those taxes relate, and should not be required to make adjustments or redetermination to those translated amounts, if actual tax payments are made within a reasonably short period of time after the close of such year. Moreover, the Congress believed that it is appropriate to use an average exchange rate for the taxable year with respect to which such foreign taxes relate for purposes of translating those taxes. On the other hand, the Congress believed that a foreign tax not paid within a reasonably short period after the close of the year to which the taxes relate should not be treated as a foreign tax for such year. By drawing a bright line between those foreign tax payment delays that do and do not require a redetermination, the Congress believed that a reasonable degree of certainty and clarity will be added to the law in this area.

Explanation of Provision

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers that take foreign income taxes into account when accrued, the Act generally provides for foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. This rule does not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).

Translation of all other foreign taxes

Under the Act, foreign taxes not eligible for application of the preceding rule generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The Act provides the Secretary of the Treasury with authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

Redetermination of foreign taxes

Under the Act, a redetermination is required if: (1) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or (3) any tax paid is refunded in whole or in part. Thus, for example, the Act provides that if at the close of the second taxable year after the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount representing the unpaid portion of that accrued tax. In other words, the previous accrual of any tax that is unpaid as of that date is denied. Similarly, if the amount of foreign taxes paid exceeds the amount accrued and claimed as a credit, a foreign tax redetermination under section 905(c) is required for the additional amount of such taxes. In cases where a redetermination is required, as under prior law, the Act specifies that the taxpayer must notify the Secretary, who will redetermine the amount of the tax for the year or years affected. In the case of indirect foreign tax credits, regulatory authority is granted to prescribe appropriate adjustments to the foreign corporation's pools of post-1986 foreign income taxes and post-1986 undistributed earnings in lieu of such a redetermination.

The Act provides specific rules for the treatment of accrued taxes that are paid more than two years after the close of the taxable year to which such taxes relate. In the case of the direct foreign tax credit, any such taxes subsequently paid are taken into account for the taxable year to which such taxes relate, but are translated into U.S. dollar amounts using the exchange rates in effect as of the time such taxes are paid. In the case of the indirect foreign tax credit, any such taxes subsequently paid are taken into account for the taxable year in which paid, and are translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that give rise to a foreign tax credit under section 901 and assume that the currency involved is not inflationary. Further assume that as of the end of year 1 the tax is unpaid. In this case, the Act provides that the taxpayer translates 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1. If the 1,000 units of tax are paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax is required. If any portion of the tax so accrued remains unpaid as of the end of year 3, however, the taxpayer is required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer pays the disallowed taxes in year 4, the taxpayer again redetermines its foreign taxes (and foreign tax credit) for year 1, but the taxes paid in year 4 are translated into U.S. dollars at the exchange rate for year 4.

Effective Date

The provision generally is effective for foreign taxes paid (in the case of taxpayers using the cash basis for determining the foreign

tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1997. The provision's changes to the foreign tax redetermination rules apply to foreign taxes which relate to taxable years beginning after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year in each of the years 1998 through 2007.

3. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes (sec. 1103 of the Act and sec. 59 of the Code)

Present and Prior Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax ("AMT"). Under prior law, the allocation and apportionment of deductions was required to be done separately for regular tax foreign tax credit limitation purposes and AMT foreign tax credit limitation purposes.

Reasons for Change

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that had allocated and apportioned deductions for regular foreign tax credit purposes generally were required to reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differences between regular taxable income and alternative minimum taxable income often are relevant primarily to U.S. source income. The Congress believed that permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation will provide an appropriate simplification of the necessary computations by eliminating the need to reallocate and reapportion every deduction.

Explanation of Provision

The Act permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source *alternative minimum* taxable income to entire alternative minimum taxable income. Under this election, foreign source regular taxable income is used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, the Congress intended that the foreign source tax-

able income in each such category generally will be reduced by a pro rata portion of that excess.

The election is available only in the first taxable year beginning after December 31, 1997 for which the taxpayer claims an AMT foreign tax credit. The Congress intended that a taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit and in which the taxpayer is subject to the AMT or would be subject to the AMT but for the availability of the AMT foreign tax credit. The election, once made, will apply to all subsequent taxable years, and may be revoked only with the consent of the Secretary of the Treasury.

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 less than $1 million per year in each of the years 1998 through 2007.

4. Simplify treatment of personal transactions in foreign currency (sec. 1104 of the Act and sec. 988 of the Code)

Present Law

When a U.S. taxpayer makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") generally arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

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

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies.

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988 of the

Code, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions are deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.

Reasons for Change

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to daily life. If an individual must treat foreign currency in this instance as property giving rise to U.S.-dollar income or loss every time the individual, in effect, "barters" the foreign currency for goods or services, the U.S. individual living in or visiting a foreign country will have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. The Congress believed that individuals should be given relief from the requirement to keep track of exchange gains on a transaction-by-transaction basis in de minimis cases.

Explanation of Provision

If an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, the Act applies nonrecognition treatment to any resulting exchange gain, provided that such gain does not exceed $200. Transactions entered into in connection with a business trip constitute personal transactions for purposes of this provision, and exchange gain resulting from such transactions is eligible for nonrecognition treatment under this provision. The provision does not change the treatment of exchange losses. The Congress understood that under other Code provisions such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year in each of the years 1998 through 2007.

5. Simplify foreign tax credit limitation for dividends from 10/50 companies (sec. 1105 of the Act and sec. 904 of the Code)

Present and Prior Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source in-

come. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitation rules apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Under prior law, dividends received by the taxpayer from *each* 10/50 company were subject to a separate foreign tax credit limitation.

Reasons for Change

The Congress found that the prior-law rule that subjects the dividends received from each so-called 10/50 company to a separate foreign tax credit limitation imposes a substantial record-keeping burden on companies and has the additional negative effect of discouraging minority-position joint ventures abroad. Indeed, the Congress was aware that recent academic research suggests that the present-law requirements may distort the form and amount of overseas investment undertaken by U.S.-based enterprises. The research findings suggest that the prior-law limitation "greatly reduces the attractiveness of joint ventures to American investors, particularly ventures in low-tax foreign countries. Aggregate data indicate that U.S. participation in international joint ventures fell sharply after [enactment of prior law in] 1986. The decline in U.S. joint venture activity is most pronounced in low-tax countries. . . . Moreover, joint ventures in low-tax countries use more debt and pay greater royalties to their U.S. parents after 1986, which reflects their incentives to economize on dividend payments."[280]

The Congress believed that the joint venture can be an efficient way for American business to exploit its know-how and technology in foreign markets. If the prior-law limitation was discouraging such joint ventures or altering the structure of new ventures, the ability of American business to succeed abroad could be diminished. The Congress believed it is appropriate to modify the prior-law limitation to promote simplicity and the ability of American business to compete abroad.

Explanation of Provision

The Act generally provides for look-through treatment to apply in characterizing dividends from 10/50 companies for foreign tax credit limitation purposes. Under the Act, any dividend from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning after December 31, 2002 is treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits.

In the case of dividends from a 10/50 company paid out of earnings and profits accumulated in a taxable year beginning before January 1, 2003, the Act provides that a single foreign tax credit limitation generally applies to all such dividends from all 10/50 companies. However, separate foreign tax credit limitations con-

[280] See, Mihir A. Desai and James R. Hines, Jr., "'Basket' Cases: International Joint Ventures after the Tax Reform Act of 1986," National Bureau of Economic Research, Working Paper #5755, September 1996.

tinue to apply to any such dividends received by the taxpayer from each 10/50 company that qualifies as a passive foreign investment company.

For purposes of this provision, the rules of section 316 apply. Accordingly, distributions are treated as made from the most recently accumulated earnings and profits. In addition, for purposes of this provision, regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $57 million in 2003, $241 million in 2004, $215 million in 2005, $227 million in 2006, and $242 million in 2007.

B. General Provisions Affecting Treatment of Controlled Foreign Corporations (secs. 1111–1113 of the Act and secs. 902, 904, 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present and Prior Law

If an upper-tier controlled foreign corporation ("CFC") sells stock of a lower-tier CFC, the gain generally is included in the income of U.S. 10-percent shareholders as subpart F income and such U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion. The inclusion was not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead it generally was characterized as passive income.

For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, under prior law, a CFC was not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC and, except as provided in regulations, the recipient of the distribution was a U.S. 10-percent shareholder in such corporation.

If subpart F income of a lower-tier CFC was included in the gross income of a U.S. 10-percent shareholder, no provision of prior law allowed adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. 10-percent shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. 10-percent shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquiror with respect to that stock.

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the

CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. A U.S. corporation also may be deemed to have paid taxes paid by a second- or third-tier foreign corporation if certain conditions are satisfied; under prior law, a U.S. corporation was not deemed to have paid taxes paid by a fourth- or lower-tier foreign corporation.

Reasons for Change

The Congress believed that complexities were caused by uncertainties and gaps in the prior-law statutory schemes for taxing gains on dispositions of stock in CFCs as dividend income or subpart F income. The Congress believed it appropriate to reduce complexities by rationalizing these rules.

The Congress also understood that certain arbitrary limitations placed on the operation of the indirect foreign tax credit may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructuring. In other cases, there was concern that these limitations may have contributed to decisions by U.S. companies against acquiring foreign subsidiaries. The Congress deemed it appropriate to ease these restrictions.

Explanation of Provision

Lower-tier CFCs

Characterization of gain on stock disposition

Under the Act, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. This provision, however, does not affect the determination of whether the corporation whose stock is sold or exchanged is a CFC.

Thus, for example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the Act, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a CFC with respect to the U.S. shareholder.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having a substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the proposal, is not excluded from foreign personal holding company in-

come under the same-country exception that applies to actual dividends.

Under the Act, for purposes of this rule, a CFC is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the CFC is treated as having gain from the sale or exchange of such stock. Thus, for example, if a CFC distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the CFC under section 311(b) as if the stock were sold to the shareholder for fair market value, the Act makes clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The Act also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 that, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. 10-percent shareholder of that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a 10/50 company. Thus, under the Act, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC, whether or not the recipient of the distribution was a U.S. 10-percent shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

Under the Act, when a lower-tier CFC earns subpart F income, and stock in that corporation is later disposed of by an upper-tier CFC, the resulting income inclusion of the U.S. 10-percent shareholders, under regulations, is to be adjusted to account for previous inclusions, in a manner similar to the adjustments provided to the basis of stock in a first-tier CFC. Thus, just as the basis of a U.S. 10-percent shareholder in a first-tier CFC rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition of the stock of that company, the subpart F income from gain on the disposition of a lower-tier CFC generally is reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier CFC.

For example, assume that a U.S. person is the owner of all of the stock of a first-tier CFC which, in turn, is the sole shareholder of a second-tier CFC. In year 1, the second-tier CFC earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier CFC disposes of the second-tier CFC's stock and recognizes $300 of income with respect to the disposition. All of that income constitutes subpart F foreign personal holding company income. Under the Act, the Secretary is granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100—the amount of year 1 subpart F income of the second-tier CFC that was included, in that year, in the U.S. person's gross income. Such an adjustment, in effect, allows for a step-up in the basis of the stock of the second-tier CFC to the extent of its subpart F income previously included in the U.S. person's gross income.

Subpart F inclusions in year of acquisition

If a U.S. 10-percent shareholder acquires the stock of a CFC from another U.S. 10-percent shareholder during a taxable year of the CFC in which it earns subpart F income, the Act reduces the acquiror's subpart F income inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced (as is the case if a dividend was paid to the previous owner of the stock) does not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Treatment of U.S. income earned by a CFC

Under the Act, an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a CFC does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a CFC earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The Act provides that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Extension of indirect foreign tax credit

The Act extends the application of the indirect foreign tax credit (secs. 902 and 960) to taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements are required to be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a CFC. Second, the U.S. corporation claiming the credit under section 902(a) must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The Act limits the application of the indirect foreign tax credit below the third tier to taxes paid in taxable years during which the payor is a CFC. Foreign taxes paid below the sixth tier of foreign corporations remain ineligible for the indirect foreign tax credit.

Effective Dates

Lower-tier CFCs.—The provision that treats gains on dispositions of stock in lower-tier CFCs as dividends under section 1248 principles applies to gains recognized on transactions occurring after the date of enactment (after August 5, 1997).

The provision that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from CFCs is effective for distributions after the date of enactment.

The provision that provides for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of CFCs from dispositions of stock in lower-tier CFCs, is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1997. Thus, the Act permits regulatory adjustments to an inclusion occurring after the effective date to account for income that was previously taxed under the subpart F provisions either prior to or subsequent to the effective date.

Subpart F inclusions in year of acquisition.—The provision that permits dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment.

Treatment of U.S. source income earned by a CFC.—The provision concerning the effect of treaty exemptions from, or reductions of, the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

Extension of indirect foreign tax credit.—The provision that extends application of the indirect foreign tax credit to certain CFCs below the third tier is effective for foreign taxes of CFCs for taxable years of such corporations beginning after the date of enactment. However, the effective date rule was not intended to preclude the creditability of foreign taxes that were creditable when paid or accrued (e.g., foreign taxes paid before the effective date by a third-tier CFC that subsequently becomes a fourth-tier subsidiary).

In the case of any chain of foreign corporations, the taxes of which would be eligible for the indirect foreign tax credit, under prior law or under the Act, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment will have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction. It was intended that no such transaction will have the effect of permitting credits for taxes which, but for such transaction, would have been noncreditable because they are taxes of a fourth-, fifth-, or sixth-tier corporation for a taxable year beginning *before* the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $5 million in 1999, $7 million in 2000, $9 million in 2001, $10 million in 2002, $10 million in 2003, $11 million in 2004, $12 million in 2005, $13 million in 2006, and $14 million in 2007.

C. Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap with Subpart F, to Allow Mark-to-Market Election, and to Require Measurement Based on Value for PFIC Asset Test (secs. 1121–1124 of the Act and secs. 1291–1298 of the Code)

Present and Prior Law

Overview

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. shareholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951–964) and the passive foreign investment company rules (secs. 1291–1297). Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551–558); the personal holding company rules (secs. 541–547); the accumulated earnings tax (secs. 531–537); and the foreign investment company and electing foreign investment company rules (secs. 1246–1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled foreign corporations

A controlled foreign corporation ("CFC") is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly or constructively (sec. 958).

Certain income of a CFC (referred to as "subpart F income") is subject to current U.S. tax. The United States generally taxes the U.S. 10-percent shareholders of a CFC currently on their pro rata shares of the subpart F income of the CFC. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property. The foreign tax credit may reduce the U.S. tax on these amounts.

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies ("PFICs"). A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for

the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income. For purposes of applying the PFIC asset test, the assets of a CFC were required under prior law to be measured using adjusted basis; the assets of a foreign corporation that is not a CFC were measured under prior law using fair market value unless the corporation elects to use adjusted basis.

Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), under which the U.S. shareholders pay tax on income realized from the PFIC and an interest charge that is attributable to the value of deferral.

Overlap between subpart F and the PFIC provisions

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive asset test described above. In such a case, under prior law, the U.S. 10-percent shareholders were subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

Reasons for Change

The anti-deferral rules for U.S. persons owning stock in foreign corporations are very complex. Moreover, the interactions between the anti-deferral regimes cause additional complexity. The overlap between the subpart F rules and the PFIC provisions was of particular concern to the Congress. The PFIC provisions, which do not require a threshold level of ownership by U.S. persons, apply where the U.S.-ownership requirements of subpart F are not satisfied. However, the PFIC provisions also applied to a U.S. shareholder that is subject to the current inclusion rules of subpart F with respect to the same corporation. The Congress believed that the additional complexity caused by this overlap was unnecessary.

The Congress also understood that the interest-charge method for income inclusion provided in the PFIC rules is a substantial source of complexity for shareholders of PFICs. Even without eliminating the interest-charge method, significant simplification could be achieved by providing an alternative income inclusion method for shareholders of PFICs. Further, some taxpayers argued that they would have preferred choosing the current-inclusion method afforded by the qualified fund election, but were unable to do so because they could not obtain the necessary information from the PFIC. Accordingly, the Congress believed that a mark-to-market election would provide PFIC shareholders with a fair alternative method for including income with respect to the PFIC.

Explanation of Provision

Elimination of overlap between subpart F and the PFIC provisions

In the case of a PFIC that is also a CFC, the Act generally treats the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule applies if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of such corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation).[281] Moreover, the rule applies for that portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder. Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock. The PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote).

If a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the provision for shareholders that are subject to subpart F, the stock held by such shareholder continues to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation. Under section 1298(b)(1), stock of a corporation that was a PFIC that was not a qualified electing fund continues to be treated as stock of a PFIC unless the shareholder makes a recognition election under rules similar to the rules of section 1291(d)(2). Pursuant to section 1291(d)(2), the shareholder may elect either to recognize gain as if such stock were sold or, in the case of a CFC, to include in income the post-1986 earnings and profits of the corporation attributable to the stock.[281a] Accordingly, the provision eliminating the overlap between the PFIC and CFC provisions does not apply to a shareholder of a corporation that was a PFIC with respect to such shareholder and that was a nonqualified fund unless the shareholder makes such an election.

If, under the Act, a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, for purposes of the PFIC provisions, the shareholder's holding period for such stock is treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earn-

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[281] In the case of an optionholder, a technical correction may be necessary to reflect this intent that the elimination of the overlap apply only to the extent the person is subject to the current inclusion rules of subpart F with respect to the corporation.

[281a] In light of this Congressional intent to allow an election with respect to either unrealized appreciation or accumulated earnings, it is hoped that the provision of the Treasury regulations which limits the availability of the latter election will be withdrawn. See Treas. Reg. sec. 1.129111–9(i).

ings of the corporation are not attributed to the period during which the shareholder was subject to subpart F with respect to the corporation and was not subject to the PFIC provisions.

For purposes of the PFIC provisions, attribution rules apply to the extent that the effect is to treat stock of a PFIC as owned by a U.S. person. In general, if 50 percent or more in value of the stock of a corporation is owned (directly or indirectly) by or for any person, such person is considered as owning a proportionate part of the stock owned directly or indirectly by or for such corporation, determined based on the person's proportionate interest in the value of such corporation's stock. However, this 50-percent limitation does not apply in the case of a corporation that is a PFIC; a person that is a shareholder of a PFIC is considered as owning a proportionate part of the stock owned directly or indirectly by or for such PFIC, without regard to whether such shareholder owns at least 50 percent of the PFIC's stock by value. It was intended that these attribution rules apply without regard to this provision treating a corporation as a non-PFIC with respect to a shareholder. Accordingly, stock owned directly or indirectly by or for a corporation that is not treated as a PFIC under this provision for the qualified portion of the shareholder's holding period nevertheless is attributed to such shareholder, regardless of the shareholder's ownership percentage of such corporation.[282]

Mark-to-market election

The Act allows a shareholder of a PFIC to make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable (as defined below). Under such an election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions are allowable under this rule only to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

Under the Act, this mark-to-market election is available only for PFIC stock that is "marketable." For this purpose, PFIC stock is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934. In addition, PFIC stock is considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value. Any option on stock that is considered marketable under the foregoing rules is treated as marketable, to the extent provided in regulations. PFIC stock also is treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of

[282] A technical correction may be necessary to clarify this result. See Title VI (sec. 10(b)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the Act treats as marketable any PFIC stock owned by a RIC that offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value. The Act treats as marketable any PFIC stock held by any other RIC that otherwise publishes net asset valuations at least annually, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuation may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the PFIC stock they hold.

The shareholder's adjusted basis in the PFIC stock is adjusted to reflect the amounts included or deducted under this election. In the case of stock owned indirectly by a U.S. person through a foreign entity (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFIC in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFIC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFIC stock.

Amounts included in income pursuant to a mark-to-market election, as well as gain on the actual sale or other disposition of the PFIC stock, are treated as ordinary income. Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally is determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark to market applies to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election.

Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities may make this election with respect to the PFIC. These constructive ownership rules apply to treat PFIC stock owned directly or indirectly by or for a foreign partnership, trust, or estate as owned proportionately by the partners or beneficiaries, except as provided in regulations. Stock in a PFIC that is thus treated as owned by a person is treated as actually owned by that person for purposes of again applying the constructive ownership rules. In the case of a U.S. person that is treated as owning PFIC stock by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the PFIC stock, as well as any disposition by the person actually owning the PFIC stock, is treated as a disposition by the U.S. person of the PFIC stock.

In addition, a CFC that owns stock in a PFIC is treated as a U.S. person that may make the election with respect to such PFIC stock. Any amount includible (or deductible) in the CFC's gross income pursuant to this mark-to-market election is treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income). The source of such amounts, however, is determined by reference to the actual residence of the CFC.

In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule applies to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule applies to RICs that make the mark-to-market election under the Act after the beginning of their holding period with respect to PFIC stock (to the extent that the RIC had not previously marked to market the stock of the PFIC).

Except as provided in the coordination rules described above, the rules of section 1291 (with respect to nonqualified funds) do not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock is treated as beginning immediately after the last taxable year for which such election applied.

A special rule applicable in the case of a PFIC shareholder that becomes a U.S. person treats the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule applies only for purposes of the mark-to-market election.

Application of PFIC asset test

Under the Act, if the stock of a foreign corporation is publicly traded for the taxable year, the PFIC asset test is applied using fair market value for purposes of measuring the PFIC's assets. For this purpose, the stock of a foreign corporation is treated as publicly traded if such stock is readily tradeable on a national securities exchange that is registered with the Securities and Exchange Commission, the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or any other exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a sound fair market value. Because the PFIC asset test is applied based on quarterly measurements of the corporation's assets, the Congress intended that a corporation the stock of which is publicly traded on each such quarterly measurement date during the taxable year will be eligible for this asset measurement rule for such taxable year. In applying the PFIC asset test, the Congress intended that the total value of a publicly-traded foreign corporation's assets generally will be treated as equal to the sum of the aggregate value of its outstanding stock plus its liabilities.

The Act did not change the rules applicable to non-publicly-traded foreign corporations for purposes of the measurement of assets in applying the PFIC asset test. Accordingly, CFCs that are not publicly traded continue to be required to measure their assets using adjusted basis, and any other foreign corporations that are not publicly traded continue to measure their assets using fair market value unless they elect to use adjusted basis.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $24 million in 1998, $23 million in 1999, $24 million in 2000, $26 million in 2001, $27 million in 2002, $28 million in 2003, $29 million in 2004, $31 million in 2005, $33 million in 2006, and $35 million in 2007.

D. Simplify Formation and Operation of International Joint Ventures (secs. 1131, 1141–1145, and 1151 of the Act and secs. 367, 721, 1491–1494, 6031, 6038, 6038B, 6046A, 6501, 6679, and 7701 of the Code)

Present and Prior Law

Under prior-law section 1491, an excise tax generally was imposed on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax was 35 percent of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the section 1491 excise tax were available. Under prior-law section 1494(c), a substantial penalty applied in the case of a failure to report a transfer described in section 1491.

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. Under prior law, these deemed royalty payments were treated as U.S. source income. A U.S. person could elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would have been subject to the prior-law section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

A partnership generally is considered to be a domestic partnership if it is created or organized in the United States or under the laws of the United States or any State. A foreign partnership generally is any partnership that is not a domestic partnership.

Reasons for Change

The Congress understood that the prior-law rules imposing an excise tax on certain transfers of appreciated property to a foreign entity unless the requirements for an exception from such excise tax were satisfied operated as a trap for the unwary. The Congress further understood that the special source rule of prior law for deemed royalty payments with respect to a transfer of an appreciated intangible to a foreign corporation was intended to discourage such transfers. The Congress believed that the imposition of enhanced information reporting obligations with respect to both foreign partnerships and foreign corporations would eliminate the need for both of these sets of rules.

Explanation of Provision

The Act repealed the sections 1491–1494 excise tax and information reporting rules that applied to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applied under prior law to transfers to a foreign estate or trust, gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, except as provided in regulations. This rule does not apply to a transfer to a trust to the extent that any person is treated as the owner of the trust under section 679. For purposes of this recognition provision, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust. Instead of the excise tax that applied under prior law to a transfer by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise described in section 367 (e.g., a capital contribution by a non-shareholder), regulatory authority is granted under section 367 to treat such transfer as a fair market value sale and to require gain recognition thereon. Instead of the excise tax that applied under prior law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority is granted to deny the nonrecognition treatment that is provided under section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

The Act repealed the rule that treated as U.S. source income any deemed royalty arising under section 367(d). Under the Act, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under section 367(d) are treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a partnership.

The Act provides detailed information reporting rules in the case of foreign partnerships. Under the Act, a foreign partnership generally is required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations. Regulatory authority is granted to provide simplified filing procedures for foreign partnerships required to file under this rule.

Under the Act, reporting rules similar to those applicable in the case of controlled foreign corporations apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner is considered to control a foreign partnership if the partner holds more than a 50 percent interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership; a partner's interest in a partnership is determined with application of constructive ownership rules similar to those provided in section 267(c) (other than paragraph (3)). Similar information reporting also will be required from a U.S. 10-percent partner of a foreign partnership that is controlled by U.S. 10-percent partners. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary of the Treasury. Under the Act, the penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties. Where under these rules more than one U.S. person would be required to file an information return with respect to the same foreign entity, the Secretary of the Treasury may by regulations provide that such information is required only from one person.

Under the Act, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10-percent interest. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary. Under the Act, the penalties for failure to report information with respect to an interest in a foreign corporation are conformed with these penalties.

Under the Act, reporting rules similar to those applicable in the case of transfers by U.S. persons to foreign corporations apply in the case of transfers to foreign partnerships. These reporting rules apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10-percent interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000. A penalty equal to 10 percent of the value of the property transferred applies to a failure to comply with these reporting requirements. However, this penalty is subject to a cap of $100,000 except in cases where the failure to comply with the reporting requirements is due to intentional disregard. Under the Act, the penalty for failure to report transfers to a foreign corporation is conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply

also results in gain recognition with respect to the property transferred.

Under the Act, in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period, as the case may be, to which such information relates does not expire before the date that is three years after the date on which such information is provided.

Under the Act, regulatory authority is granted to provide rules treating a partnership as a domestic or foreign partnership, where such treatment is more appropriate, without regard to where the partnership is created or organized. Regulations issued under this grant of regulatory authority generally will apply only to partnerships created or organized after the date such regulations are filed with the Federal Register (or, if earlier, the date of a public notice substantially describing the expected contents of the regulations). Section 7805(b)(2), which allows regulations to have retroactive effect if issued within eighteen months of enactment of the relevant statutory provision, is not applicable in this case. Accordingly, regulations issued under this grant of regulatory authority generally will not be applied to reclassify pre-existing partnerships. The Congress intended that the general rule for classifying a partnership as domestic or foreign will continue to be the place where the partnership is created or organized (or the laws under which it is created or organized), and that the regulations will provide a different classification result only in unusual cases. The Congress also expected that any regulations will avoid period-by-period reclassifications of partnerships. It is expected that a recharacterization of a partnership under such regulations will be based only on material factors such as the residence of the partners and the extent to which the partnership is engaged in business in the United States or earns U.S. source income. It also is expected that such regulations will provide guidance regarding the determination of whether an entity that is a partnership for Federal income tax purposes is to be considered to be created or organized in the United States or under the law of the United States or any State.

Effective Date

The provisions with respect to the repeal of sections 1491–1494 were effective on the date of enactment (August 5, 1997). The provisions with respect to the source of a deemed royalty under section 367(d) are effective both for transfers made, and for royalties deemed received, on or after the date of enactment.

The provisions regarding information reporting with respect to foreign partnerships generally are effective for partnership taxable years beginning after the date of enactment. The provisions regarding information reporting with respect to interests in, and transfers to, foreign partnerships are effective for transfers to, and changes in interests in, foreign partnerships after the date of enactment. Taxpayers may elect to apply these rules to transfers made after August 20, 1996 (and thereby avoid a penalty under section 1494(c)) and the Secretary may prescribe simplified reporting requirements for these cases. The provision with respect to the statute of limitations in the case of noncompliance with reporting re-

quirements is effective for information returns due after the date of enactment.

Regulations issued under the provision granting regulatory authority with respect to the treatment of partnerships as foreign or domestic will apply only to partnerships created or organized after the date such regulations are filed with the Federal Register or described in a public notice.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1998, less than $500,000 in 1999, $1 million in 2000, $1 million in 2001, $1 million in 2002, $1 million in 2003, $1 million in 2004, $1 million in 2005, $1 million in 2006, and $2 million in 2007.

E. Modification of Reporting Threshold for Stock Ownership of a Foreign Corporation (sec. 1146 of the Act and sec. 6046 of the Code)

Present and Prior Law

Several provisions of the Code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer or director, or who owns at least 10 percent of the stock, of a foreign corporation that is a controlled foreign corporation or a foreign personal holding company to file Form 5471 annually.

Section 6046 mandates the filing of information returns by certain U.S. persons with respect to a foreign corporation upon the occurrence of certain events. Under prior law, the U.S. persons required to file these information returns were those who acquired 5 percent or more of the value of the stock of a foreign corporation, others who became U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who were officers or directors of foreign corporations with such U.S. ownership.

A failure to file the required information return under section 6038 may result in monetary penalties or reduction of foreign tax credit benefits. A failure to file the required information returns under sections 6035 or 6046 may result in monetary penalties.

Reasons for Change

The Congress believed it appropriate to make the stock ownership threshold at which reporting with respect to an ownership interest in a foreign corporation is required generally parallel to the thresholds that apply in the case of other annual information reporting with respect to foreign corporations. The Congress believed that increasing the threshold for such reporting from 5 percent to 10 percent will reduce the compliance burdens on taxpayers.

Explanation of Provision

The Act increases the threshold for stock ownership of a foreign corporation that results in information reporting obligations under section 6046 from 5 percent (based on value) to 10 percent (based on vote or value).

Effective Date

The provision is effective for reportable transactions occurring after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million in 1998, $1 million in 1999, $2 million per year in each of 2000 through 2004, and $3 million per year in each of 2005 through 2007.

F. Other Foreign Simplification Provisions

1. Transition rule for certain trusts (sec. 1161 of the Act and sec. 7701(a)(30) of the Code)

Present and Prior Law

Under rules enacted pursuant to the Small Business Job Protection Act of 1996, a trust is considered to be a U.S. trust if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, U.S. persons must have the authority to control all substantial decisions of the trust. A trust that does not satisfy both of these criteria is considered to be a foreign trust. These rules for defining a U.S. trust generally are effective for taxable years of a trust that begin after December 31, 1996. A trust that qualified as a U.S. trust under prior law could fail to qualify as a U.S. trust under these new criteria.

Reasons for Change

The change in the criteria for qualification as a U.S. trust could cause large numbers of existing domestic trusts to become foreign trusts, unless they are able to make the modifications necessary to satisfy the new criteria. The Congress believed that an election is appropriate for those existing domestic trusts that prefer to continue to be subject to tax as U.S. trusts.

Explanation of Provision

Under the Act, the Secretary of the Treasury is granted authority to allow nongrantor trusts that had been treated as U.S. trusts under prior law to elect to continue to be treated as U.S. trusts, notwithstanding the new criteria for qualification as a U.S. trust.

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 $1 million in 1998, $3 million in 1999, and $5 million per year in each of 2000 through 2007.

2. Simplify stock and securities trading safe harbor (sec. 1162 of the Act and sec. 864(b)(2)(A) of the Code)

Present and Prior Law

A nonresident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation at graduated rates on its net income that is effectively connected with the trade or business. Under a "safe harbor" rule, foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business for this purpose.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stocks or securities. In addition, under prior law, if the principal business of the foreign corporation was trading in stocks or securities for its own account, the safe harbor generally did not apply if the principal office of the corporation was in the United States.

For foreign persons who invest in securities trading partnerships, the safe harbor applies only if the partnership is not a dealer in stocks and securities. In addition, under prior law, if the principal business of the partnership was trading in stocks or securities for its own account, the safe harbor generally did not apply if the principal office of the partnership was in the United States.

Under Treasury regulations which apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to the operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account (Treas. reg. sec. 1.864–2(c)(2)(ii) and (iii)). Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

Reasons for Change

The Congress believed that the foreign principal office requirement did not promote any important tax policy and had been easily circumvented. The stock and securities trading safe harbor serves to promote foreign investment in U.S. capital markets. The Congress believed that the elimination of the principal office rule would facilitate foreign investment in U.S. markets. In this regard, the Congress noted that, because the location of a partnership's or foreign corporation's principal office was determined by the location of certain administrative functions rather than the location of management and investment decisions, the requirement of a foreign principal office was met even if only administrative functions were performed abroad.

Explanation of Provision

The Act modifies the stock and securities trading safe harbor by eliminating the requirement for both partnerships and foreign corporations that trade stocks or securities for their own accounts that the entity's principal office not be within the United States.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 per year in each of 1998 through 2007.

3. Clarification of determination of foreign taxes deemed paid (sec. 1163(a) of the Act and sec. 902 of the Code)

Present and Prior Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings. The foreign corporation's post-1986 foreign income taxes is the sum of the foreign income taxes with respect to the taxable year in which the dividend is distributed plus certain foreign income taxes with respect to prior taxable years (beginning after December 31, 1986).

Reasons for Change

The Congress believed it appropriate to clarify the determination of foreign taxes deemed paid for purposes of the indirect foreign tax credit.

Explanation of Provision

The Act clarifies that, for purposes of the deemed paid credit under section 902 for a taxable year, a foreign corporation's post-1986 foreign income taxes includes foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. No inference is intended regarding the determination of foreign taxes deemed paid under prior law.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 per year in each of the years 1998 through 2007.

4. Clarification of foreign tax credit limitation for financial services income (sec. 1163(b) of the Act and sec. 904 of the Code)

Present Law

Under section 904, separate foreign tax credit limitations apply to various categories of income. Two of these separate limitation categories are passive income and financial services income. For purposes of the separate foreign tax credit limitation applicable to passive income, certain income that is treated as high-taxed income is excluded from the definition of passive income. For purposes of the separate foreign tax credit limitation applicable to financial services income, the definition of financial services income generally incorporates passive income as defined for purposes of the separate limitation applicable to passive income.

Reasons for Change

The Congress believed it appropriate to clarify that high-taxed income is not excluded from the separate foreign tax credit limitation for financial services income.

Explanation of Provision

The Act clarifies that the exclusion of income that is treated as high-taxed income does not apply for purposes of the separate foreign tax credit limitation applicable to financial services income. No inference is intended regarding the treatment of high-taxed income for purposes of the separate foreign tax credit limitation applicable to financial services income under prior law.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in each of the years 1998 through 2007.

G. Other Foreign Provisions

1. Eligibility of licenses of computer software for foreign sales corporation benefits (sec. 1171 of the Act and sec. 927 of the Code)

Present and Prior Law

Under special tax provisions that provide an export benefit, a portion of the foreign trade income of an eligible foreign sales cor-

poration ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights *other than* films, tapes, records, or similar reproductions for commercial or home use. The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Temp. Treas. Reg. sec. 1.927(a)–1T(f)(3)). Under prior law, the statutory exclusion for intangible property did not contain any specific reference to computer software. However, the temporary Treasury regulations provided that a copyright on computer software did not constitute export property, and that standardized, mass marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Temp. Treas. Reg. sec. 1.927(a)–1T(f)(3)).

Reasons for Change

For purposes of the FSC provisions, films, tapes, records and similar reproductions explicitly were included within the definition of export property. In light of technological developments, the Congress believed that computer software is virtually indistinguishable from the enumerated films, tapes, and records. Accordingly, the Congress believed that the benefits of the FSC provisions similarly should be available to computer software.

Explanation of Provision

The Act provides that computer software licensed for reproduction abroad is not excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with a right to reproduce is eligible for the benefits of the FSC provisions. In light of the rapid innovations in the computer and software industries, the Congress intended that the term "computer software" be construed broadly to accommodate technological changes in the products produced by both industries. No inference is intended regarding the qualification as export property of computer software licensed for reproduction abroad under prior law.

Effective Date

The provision applies to gross receipts from computer software licenses attributable to periods after December 31, 1997. Accordingly, in the case of a multi-year license, the provision applies to gross receipts attributable to the period of such license that is after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $27 million in 1998, $42 million in 1999, $146 million in 2000, $173 million in 2001, $180 million in 2002, $191 million in 2003, $202 million in 2004, $227 million in 2005, $252 million in 2006, and $277 million in 2007.

2. Increase dollar limitation on section 911 exclusion (sec. 1172 of the Act and sec. 911 of the Code)

Present and Prior Law

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. A credit against the U.S. income tax imposed on foreign source income is allowed for foreign taxes paid on such income.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year or (2) present in a foreign country or countries for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. Under prior law, the maximum exclusion for foreign earned income for a taxable year was $70,000.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

Reasons for Change

The Congress recognized that for U.S. businesses to be effective competitors overseas it is necessary to dispatch U.S. citizens or residents to sites of foreign operations. Being stationed abroad typi-

cally imposes additional financial burdens on the employee and his or her family. These burdens may arise from maintaining two homes (one in the United States and one abroad), additional personal travel to maintain family ties, or the added expenses of living in a foreign location that has a high cost of living. Businesses often remunerate their employees for these additional burdens by paying higher wages. Because the increased remuneration is offset by larger burdens, the remuneration does not truly reflect an increase in economic well being. The Congress, therefore, believed that the exclusion of section 911 is a simple way to prevent taxpayers from facing an increased tax burden when there has been no increase in economic well being by accepting an overseas assignment.

The Congress further observed that the prior-law $70,000 exclusion remained unchanged for the past 10 years, while the extra costs from working abroad have increased with worldwide inflation. The Congress, therefore, believed it appropriate to increase the exclusion permitted under section 911. In addition, as a rough measure for the increased burden that may be expected to arise from future inflation, the Congress believed it appropriate to index the level of the section 911 exclusion amount to future changes in the domestic cost of living.

Explanation of Provision

Under the Act, the $70,000 limitation on the exclusion for foreign earned income is increased to $80,000, in increments of $2,000 each year beginning in 1998. Under the Act, the limitation on the exclusion for foreign earned income then is indexed for inflation beginning in 2008 (for inflation after 2006).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $15 million in 1998, $30 million in 1999, $50 million in 2000, $67 million in 2001, $82 million in 2002, $97 million in 2003, $103 million in 2004, $111 million in 2005, $119 million in 2006, and $127 million in 2007.

3. Treatment of certain securities positions under the subpart F investment in U.S. property rules (sec. 1173 of the Act and sec. 956 of the Code)

Present and Prior Law

Under the rules of subpart F (secs. 951–964), the U.S. 10-percent 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 distributed currently to the shareholders. The U.S. 10-percent 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 U.S. 10-percent shareholders also are subject to current U.S. tax on

their shares of the CFC's earnings to the extent invested by the CFC in certain U.S. property.

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is based on the CFC's average investment in U.S. property for such year. For this purpose, the U.S. property held by the CFC must be measured as of the close of each quarter in the taxable year. U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, obligations of a U.S. person, and the right to use certain intellectual property in the United States. Exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain trade or business obligations, and stock or debts of certain unrelated U.S. corporations. For purposes of these rules, the term "obligation" generally includes any bond, note, debenture, certificate, bill receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest. Temp. Treas. Reg. section 1.956–2T(d)(2).

Reasons for Change

The Congress believed that guidance is needed regarding the treatment of certain transactions entered into by securities dealers in the ordinary course of business under the investment in U.S. property provisions of subpart F. The Congress believed that deposits of collateral or margin in the ordinary course of business should not give rise to an income inclusion as an investment in U.S. property under the provisions of subpart F. Similarly, the Congress believed that repurchase agreements entered into in the ordinary course of business should not give rise to an income inclusion as an investment in U.S. property.

Explanation of Provision

The Act provides two additional exceptions from the definition of U.S. property for purposes of the subpart F rules. Both exceptions relate to transactions entered into by a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer.

The first exception covers the deposit of collateral or margin by a securities or commodities dealer, or the receipt of such a deposit by a dealer in securities or commodities, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer. This exception applies to deposits of margin or collateral for securities loans, notional principal contracts, options contracts, forward contracts, futures contracts, and any other financial transaction with respect to which the Secretary of the Treasury determines that the posting of collateral or margin is customary.

The second exception covers repurchase agreement transactions and reverse repurchase agreement transactions entered into by or with a dealer in securities or commodities in the ordinary course of its business as a securities or commodities dealer. The exception applies only to the extent that the obligation under the transaction

does not exceed the fair market value of readily marketable securities transferred or otherwise posted as collateral.

For purposes of these two additional exceptions under section 956, the term "dealer in securities" has the meaning provided under section 475 and the term "dealer in commodities" means futures commission merchants and dealers in commodities within the meaning of the new definition that is added to section 475 by the Act. No inference is intended regarding the treatment of these transactions under prior law. In addition, the addition of these two exceptions under section 956 is not intended to create any inference regarding the treatment of an obligation of a U.S. person to return stock that is borrowed pursuant to a securities loan.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1997, 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 $1 million in 1998 and by $2 million per year in each of the years 1999 through 2007.

4. Treat service income of nonresident alien individuals earned on foreign ships as foreign source income and disregard the U.S. presence of such individuals (sec. 1174 of the Act and secs. 861, 863, 872, 3401, and 7701 of the Code)

Present and Prior Law

Nonresident alien individuals generally are subject to U.S. taxation and withholding on their U.S. source income. Compensation for labor and personal services performed within the United States was considered U.S. source unless such income qualified for a de minimis exception. To qualify for the exception, the compensation paid to a nonresident alien individual must not exceed $3,000, the compensation must reflect services performed on behalf of a foreign employer, and the individual must be present in the United Sates for not more than 90 days during the taxable year. Special rules apply to exclude certain items from the gross income of a nonresident alien. An exclusion applies to gross income derived by a nonresident alien individual from the international operation of a ship if the country in which such individual is resident provides a reciprocal exemption for U.S. residents. However, this exclusion does not apply to income from personal services performed by an individual crew member on board a ship. Consequently, under prior law, wages exceeding $3,000 in a taxable year that were earned by nonresident alien individual crew members of a foreign ship while the vessel was within U.S. territory were subject to income taxation by the United States.

U.S. residents are subject to U.S. tax on their worldwide income. In general, a non-U.S. citizen is considered to be a resident of the

United States if the individual (1) has entered the United States as a lawful permanent U.S. resident 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 three-year period computed by weighting toward the present year (the "substantial presence test"). An individual generally is treated as present in the United States on any day if such individual is physically present in the United States at any time during the day. Certain categories of individuals (e.g., foreign government employees and certain students) are not treated as U.S. residents even if they are present in the United States for the requisite period of time. Under prior law, crew members of a foreign vessel who were on board the vessel while it was stationed within U.S. territorial waters were treated as present in the United States.

Reasons for Change

The Congress understood that U.S. tax rules impose a significant compliance burden on nonresident alien individuals who are present in the United States for short periods of time as members of the regular crew of a foreign vessel and who may not be permitted to leave such vessel during those periods. The Congress believed that an exemption from U.S. tax is appropriate for the income earned by a nonresident alien individual from personal services performed as a member of the regular crew of a foreign vessel. Moreover, the Congress believed that such an individual's presence in the United States as a regular crew member of a foreign vessel should not be taken into account for purposes of determining whether the individual is treated as a resident alien for U.S. tax purposes.

Explanation of Provision

The Act treats gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship as income from foreign sources. Thus, such income is exempt from U.S. income and withholding tax. However, the treatment of income of a nonresident alien crew member of a foreign vessel as foreign source income will not apply for purposes of the pension rules and certain employee benefit provisions. In addition, for purposes of determining whether an individual is a U.S. resident under the substantial presence test, the Act provides that any day that such individual is present as a member of the regular crew of a foreign vessel is disregarded if the individual does not otherwise engage in trade or business within the United States on such day.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $4 million in 1999, and $3 million per year in each of 2000 through 2007.

5. Exceptions under subpart F for active financing income (sec. 1175 of the Act (canceled pursuant to Line Item Veto Act) and sec. 954 of the Code)

Present and Prior Law

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consisted of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the preceding types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. The Act added two additional categories of foreign personal holding company income: income from notional principal contracts and payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. reg. sec. 1.953–1(a)). Investment income allocable to risks located within the CFC's country of organization generally is taxable as foreign personal holding company income.

Special rules apply with respect to certain captive insurance companies. The definition of CFC and the application of the current inclusion rules to U.S. shareholders are broadened in the case of such a captive.

Reasons for Change

The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily moveable. Prior to the enactment of the 1986 Act, exceptions from foreign personal holding company income were provided for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company. The Congress was concerned that the 1986 Act's repeal of these exceptions resulted in the extension of the subpart F provisions to income that is neither passive nor easily moveable. The Congress believed that the provision of exceptions from foreign personal holding company income for income from the active conduct of an insurance, banking, financing or similar business is appropriate.

Explanation of Canceled Provision

Under the Act, a temporary exception from foreign personal holding company income would have applied to income that is derived in the active conduct of a banking, financing or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived in the active conduct of a banking, financing, or similar business generally would have been determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. However, in the case of a corporation that is engaged in the active conduct of a banking or securities business, the income that is eligible for this exception would have been determined under the principles applicable in determining the income which is treated as nonpassive income for purposes of the passive foreign investment company provisions. The Congress generally intended that the income of a corporation engaged in the active conduct of a banking or securities business that would have been eligible for this exception would have been the income that is treated as nonpassive under the regulations proposed under prior law section 1296(b). See Prop. Treas. Reg. secs. 1.1296–4 and 1.1296–6. In this regard, the Congress intended that eligible income would have included income or gains with respect to foreclosed property which is incident to the active conduct of a banking business. The Act would have directed the Secretary of the Treasury to prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents, and royalties from related persons.

For purposes of the temporary exception, a corporation would have been considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking or securities business or is a qualified bank affiliate or qualified securities affiliate. In this regard, the Congress intended that a corporation would have been considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b); the Congress further intended that qualified bank affiliates and qualified securities affiliates would have been as determined under such

proposed regulations. See Prop. Treas. Reg. secs. 1.1296–4 and 1.1296–6.

Alternatively, a corporation would have been considered to be engaged in the active conduct of a banking, financing or similar business if more than 70 percent of its gross income is derived from such business from transactions with unrelated persons located within the country under the laws of which the corporation is created or organized. For this purpose, income derived by a qualified business unit of a corporation from transactions with unrelated persons located in the country in which the qualified business unit maintains its principal office and conducts substantial business activity would have been treated as derived by the corporation from transactions with unrelated persons located within the country in which the corporation is created or organized. A person other than a natural person would have been considered to be located within the country in which it maintains an office through which it engages in a trade or business and by which the transaction is effected. A natural person would have been treated as located within the country in which such person is physically located when such person enters into the transaction.

The Act would have provided a temporary exception from foreign personal holding company income for certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. The rules of this provision of the Act differ from the rules of present-law section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance with the rules of subchapter L of the Code. The Congress believed that review of the rules of this provision would be appropriate when final guidance under section 953 is published by the Treasury Department.

The Act would have provided a temporary exception for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums (as defined for purposes of the provision). For this purpose, in the case of contracts regulated in the country in which sold as property, casualty, or health insurance contracts, unearned premiums and reserves would have been defined as unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums would have been determined in accordance with section 832(b)(4), and reserves for losses incurred would have been determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, the following three alternative rules for determining reserves would have been provided under the Act. The Congress intended that any one of the three rules could have been elected with respect to a particular line of business.

First, reserves for such contracts could have been determined generally under the rules applicable to domestic life insurance companies under subchapter L of the Code, using the methods there specified, but substituting for the interest rates in Code section 807(d)(2)(B) an interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)).

Second, the reserves for such contracts could have been determined generally using a preliminary term foreign reserve method, except that the interest rate to be used would be the interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term AFR. If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in the country in which the company is created or organized, then such method would have been the method that applies for purposes of this election.

Third, reserves for such contracts could have been determined to be equal to the net surrender value of the contract (as defined in section 807(e)(1)(A)).

In no event could the reserve for any contract at any time have exceeded the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve. This rule would have applied, whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The Act also would have provided a temporary exception for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health insurance contacts, and (2) the greater of 10 percent of reserves, or, in the case of a qualifying insurance company that is a startup company, $10 million. For this purpose, a startup company would have been a company (including any predecessor) that has not been engaged in the active conduct of an insurance business for more than 5 years. The Congress intended that the 5-year period would have commenced when the foreign company first is engaged in the active conduct of an insurance business. If the foreign company was formed before being acquired by the U.S. shareholder, the 5-year period would have commenced when the acquired company first was engaged in the active conduct of an insurance business. The Congress intended that in the event of the acquisition of a book of business from another company through an assumption or indemnity reinsurance transaction, the period would have commenced when the acquiring company first engaged in the active conduct of an insurance business, except that if more than a substantial part (e.g., 80 percent) of the business of the ceding company is acquired, then the 5-year period would have commenced when the ceding company first engaged in the active conduct of an insurance business. In addition, the Congress did not intend that reinsurance transactions among related persons be used to multiply the number of 5-year periods.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary excep-

tion, the Act would have provided that, under rules prescribed by the Secretary, income is allocated to contracts as follows. In the case of contracts that are separate-account-type contracts (including variable contracts not meeting the requirements of sec. 817), only the income specifically allocable to such contracts would have been taken into account. In the case of other contracts, income not specifically allocable would have been allocated ratably among such contracts.

Under the Act, a qualifying insurance company would have been defined as any entity which: (1) is regulated as an insurance company under the laws of the country in which it is incorporated; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks situated within its country of incorporation; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The Act would have provided that this provision does not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to section 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

The Act would have provided an anti-abuse rule applicable for purposes of these temporary exceptions. For purposes of applying these exceptions, items with respect to a transaction or series of transactions would have been disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

The Act also would have provided an exception from foreign base company services income for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business or is a qualifying insurance company.

The Congress recognized that insurance, banking, financing, and similar businesses are businesses the active conduct of which involves the generation of income, such as interest and dividends, of a type that generally is treated as passive for purposes of subpart F. For purposes of this temporary provision, the Congress intended to delineate the income derived in the active conduct of such businesses, while retaining the anti-deferral rules of subpart F with respect to income not derived in the active conduct of these financial services businesses. However, the Congress recognized that the line between income derived in the active conduct of such businesses and income otherwise derived by entities so engaged can be difficult to draw. The Congress believed that the issues of the determination of income derived in the active conduct of such businesses and the potential mobility of the business activity and income recognition of insurance, banking, financing, and similar businesses require further study. In the event that it became necessary to consider a possible extension of the provision in the future, the Con-

gress invited the comments of taxpayers and the Treasury Department regarding these issues.

Effective Date

The provision would have applied only to taxable years of foreign corporations beginning in 1998, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

Revenue Effect

The provision was estimated to have reduced Federal fiscal year budget receipts by $23 million in 1998, $68 million in 1999, and $3 million in 2000.

Line Item Veto Action

This provision was identified by the Joint Committee on Taxation as a limited tax benefit within the meaning of the Line Item Veto Act. The President canceled this provision pursuant to the Line Item Veto Act. A modified version of the provision was included in H.R. 2513, which was passed by the House on November 8, 1997.[283]

[283] See report of the House Committee on Ways and Means, H. Rept. 105–318, Part I, October 9, 1997.

TITLE XII. SIMPLIFICATION PROVISIONS RELATING TO INDIVIDUALS AND BUSINESSES

A. Provisions Relating to Individuals

1. Modifications to standard deduction of dependents; AMT treatment of certain minor children (sec. 1201 of the Act and secs. 63(c) and 59(j) of the Code)

Present and Prior Law

Standard deduction of dependents.—Under present law, the standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return can not exceed the lesser of (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) or (2) the greater of $500 (indexed)[284] or the dependent's earned income (sec. 63(c)(5)).

Taxation of unearned income of children under age 14.—The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. The portion of the child's unearned income which is taxed at the parent's top marginal rate is the amount by which the child's unearned income is more than the sum of (1) $500[285] (indexed) plus (2) the greater of (a) $500[286] (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income (sec. 1(g)).

Alternative minimum tax ("AMT") exemption for children under age 14.—Single taxpayers are entitled to an exemption from the alternative minimum tax ("AMT") of $33,750. However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused alternative minimum tax exemption of the child's custodial parent, limited to the sum of earned income and $1,000 (indexed)[287] (sec. 59(j)).

Reasons for Change

The Congress believed that significant simplification of the existing income tax system could be achieved by providing larger exemptions such that taxpayers with incomes less than the exemption are not required to compute and pay any tax. The Congress particularly believed that the present-law exemptions of dependent children were too small.

Explanation of Provision

Standard deduction of dependents.—The Act increases the standard deduction for a taxpayer with respect to whom a dependency exemption is allowed on another taxpayer's return to the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500[288] (indexed for inflation as under present law), or

[284] Projected to be $700 for 1998.
[285] Projected to be $700 for 1998.
[286] Projected to be $700 for 1998.
[287] Projected to be $1,400 for 1998.
[288] Projected to be $700 for 1998.

(b) the individual's earned income plus $250. The $250 amount is indexed for inflation after 1998.

Alternative minimum tax exemption for children under age 14.—The Act increases the AMT exemption amount for a child under age 14 to the lesser of (1) $33,750 or (2) the sum of the child's earned income plus $5,000. The $5,000 amount is indexed for inflation after 1998.

Effective Date

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

Revenue Effect

The provision is estimated to decrease Federal fiscal year budget receipts by $2 million in 1998, $38 million in 1999, $35 million per year in each of years 2000 through 2004, $38 million in 2005, $37 million in 2006, and $36 million in 2007.

2. Increase de minimis threshold for estimated tax to $1,000 for individuals (sec. 1202 of the Act and sec. 6654 of the Code)

Present and Prior Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax (sec. 6654). An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year. These percentages are further modified for certain years. For example, see section 1091 of the Act. Income tax withholding from wages is considered to be a payment of estimated taxes. In general, payment of estimated taxes must be made quarterly. The addition to tax is not imposed where the total tax liability for the year, reduced by any withheld tax, is less than $500.

Reasons for Change

The Congress determined that raising the individual estimated tax de minimis threshold will simplify the tax laws for a number of taxpayers.

Explanation of Provision

The Act increases the $500 individual estimated tax de minimis threshold to $1,000.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $134 million in 1998, $17 million in 1999, $18 million in 2000, $19 million in 2001, $20 million in 2002, $21 million in 2003, $22 million in 2004, $24 million in 2005, $25 million in 2006, and $26 million in 2007.

3. Treatment of certain reimbursed expenses of rural letter carrier's vehicles (sec. 1203 of the Act and sec. 162 of the Code)

Present and Prior Law

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

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

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150 percent of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income.

Reasons for Change

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

Explanation of Provision

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

Effective Date

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

Revenue Effect

The provision is estimated to decrease Federal fiscal year budget receipts by less than $500,000 in 1998, $1 million in 1999, $1 million in 2000, $1 million in 2001, $1 million in 2002, $1 million in 2003, $1 million in 2004, $1 million in 2005, $1 million in 2006, and $1 million in 2007.

4. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 1204 of the Act and sec. 162 of the Code)

Present and Prior Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Reasons for Change

The Congress believed that it would be inappropriate if this provision in the tax laws were to be a hindrance to the investigation of a Federal crime.

Explanation of Provision

The one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate

or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied). Prosecuting a Federal crime or providing support services to the prosecution of a Federal crime is considered part of investigating a Federal crime.[289]

Effective Date

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to decrease Federal fiscal year budget receipts by less than $500,000 in each of 1998 through 2007.

5. Payment of taxes by commercially acceptable means (sec. 1205 of the Act and sec. 6311 of the Code)

Present and Prior Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by Treasury regulations (sec. 6311).

Reasons for Change

Additional payment mechanisms (such as credit cards, debit cards, and charge cards) have become commonly used and reliable forms of payment. Some taxpayers may find paying taxes by these mechanisms more convenient than paying by check or money order.

Explanation of Provision

In general

The Internal Revenue Service (IRS) is engaged in a long-term modernization of its information systems, the Tax Systems Modernization (TSM) Program. This modernization is intended to address deficiencies in the current IRS information systems and to plan effectively for future information system needs and requirements. The systems changes are designed to reduce the burden on taxpayers, generate additional revenue through improved voluntary compliance, and achieve productivity gains throughout the IRS. One key element of this program is electronic filing of tax returns.

At the present time, increasing reliance is being placed upon electronic funds transfers for payment of obligations. In light of this, the IRS seeks to integrate these payment methods in its TSM program, including electronic filing of returns, as well as into its traditional collection functions. The Act allows the IRS to accept payment by any commercially acceptable means that the Secretary deems appropriate, to the extent and under the conditions provided

[289] See Title VI (sec. 611(a)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

in Treasury regulations. This will include, for example, electronic funds transfers, including those arising from credit cards, debit cards, and charge cards.

The IRS contemplates that it will proceed to negotiate contracts to implement this provision with one or more private sector credit and debit card systems. The Act provides that the IRS may not pay any fees or provide any other consideration with respect to any such contracts.

Billing error resolution

In the course of processing these transactions, it will be necessary to resolve billing errors and other disputes. The Internal Revenue Code contains mechanisms for the determination of tax liability, defenses and other taxpayer protections, and the resolution of disputes with respect to those liabilities. The Truth-in-Lending Act contains provisions for determination of credit card liabilities, defenses and other consumer protections, and the resolution of disputes with respect to these liabilities.

The Act excludes credit card, debit card, and charge card issuers and processing mechanisms from the resolution of tax liability, but makes IRS subject to the Truth-in-Lending provisions insofar as those provisions impose obligations and responsibilities with regard to the "billing error" resolution process. It is not intended that consumers obtain additional ways to dispute their tax liabilities under the Truth-in-Lending provisions.

The Act also specifically includes the use of debit cards in this provision and provides that the corresponding defenses and "billing error" provisions of the Electronic Fund Transfer Act will apply in a similar manner.

The Act adds new section 6311(d)(3) to the Code. This section describes the circumstances under which section 161 of the Truth-in-Lending Act ("TILA") and section 908 of the Electronic Fund Transfer Act ("EFTA") apply to disputes that may arise in connection with payments of taxes made by credit card or debit card. Subsections (A) through (C) recognize that "billing errors" relating to the credit card account, such as an error arising from a credit card transaction posted to a cardholder's account without the cardholder's authorization, an amount posted to the wrong cardholder's account, or an incorrect amount posted to a cardholder's account as a result of a computational error or numerical transposition, are governed by the billing error provisions of section 161 of TILA. Similarly, subsections 6311(d)(3)(A)–(C) provide that errors such as those described above which arise in connection with payments of internal revenue taxes made by debit card, are governed by section 908 of EFTA.

The Internal Revenue Code provides that refunds are only authorized to be paid to the person who made the overpayment (generally the taxpayer). Subsection 6311(d)(3)(E), however, provides that where a taxpayer is entitled to receive funds as a result of the correction of a billing error made under section 161 of TILA in connection with a credit card transaction, or under section 908 of EFTA in connection with a debit card transaction, the IRS is authorized to utilize the appropriate credit card or debit card system to initiate a credit to the taxpayer's credit card or debit card ac-

count. The IRS may, therefore, provide such funds through the taxpayer's credit card or debit card account rather than directly to the taxpayer.

On the other hand, subsections 6311(d)(3)(A)–(C) provide that any alleged error or dispute asserted by a taxpayer concerning the merits of the taxpayer's underlying tax liability or tax return is governed solely by existing tax laws, and is not subject to section 161 or section 170 of TILA, section 908 of EFTA, or any similar provisions of State law. Absent the exclusion from section 170 of TILA, in a collection action brought against the cardholder by the card issuer the cardholder might otherwise assert as a defense that the IRS had incorrectly computed his tax liability. A collection action initiated by a credit card issuer against the taxpayer/cardholder will be an inappropriate vehicle for the determination of a taxpayer's tax liability, especially since the United States will not be a party to such an action.

Similarly, without the exclusion from section 161 of TILA and section 908 of EFTA, a taxpayer could contest the merits of his tax liability by putting the charge which appears on the credit card bill in dispute. Pursuant to TILA or EFTA, the taxpayer's card issuer will have to investigate the dispute, thereby finding itself in the middle of a dispute between the IRS and the taxpayer. It is believed that it is improper to attempt to resolve tax disputes through the billing process. It is also noted that the taxpayer retains the traditional, existing remedies for resolving tax disputes, such as resolving the dispute administratively with the IRS, filing a petition with the Tax Court after receiving a statutory notice of deficiency, or paying the disputed tax and filing a claim for refund (and subsequently filing a refund suit if the claim is denied or not acted upon).

Creditor status

The TILA imposes various responsibilities and obligations on creditors. Although the definition of the term "creditor" set forth in 15 U.S.C. sec. 1602 is limited, and will generally not include the IRS, in the case of an open-end credit plan involving a credit card, the card issuer and any person who honors the credit card are, pursuant to 15 U.S.C. sec. 1602(f), creditors.

In addition, 12 CFR sec. 226.12(e) provides that the creditor must transmit a credit statement to the card issuer within 7 business days from accepting the return or forgiving the debt. There is a concern that the response deadlines otherwise imposed by 12 CFR sec. 226.12(e), if applicable, will be difficult for the IRS to comply with (given the volume of payments the IRS is likely to receive in peak periods). This could subject the IRS to unwarranted damage actions. Consequently, the bill generally provides an exception to creditor status for the IRS.

Privacy protections

The Act also addresses privacy questions that arise from the IRS' participation in credit card processing systems. It is believed that taxpayers expect that the maximum possible protection of privacy will be accorded any transactions they have with the IRS. Accordingly, the Act provides the greatest possible protection of taxpayers'

privacy that is consistent with developing and operating an efficient tax administration system. It is expected that the principle will be fully observed in the implementation of this provision.

A key privacy issue is the use and redisclosure of tax information by financial institutions for purposes unrelated to the processing of credit card charges, i.e., marketing and related uses. To accept credit card charges by taxpayers, the IRS will have to disclose tax information to financial institutions to obtain payment and to resolve billing disputes. To obtain payment, the IRS will have to disclose, at a minimum, information on the "credit slip," i.e., the dollar amount of the payment and the taxpayer's credit card number.

The resolution of billing disputes may require the disclosure of additional tax information to financial institutions. In most cases, providing a copy of the credit slip and verifying the transaction amount will be sufficient. Conceivably, financial institutions could require some information regarding the underlying liability even where the dispute concerns a "billing dispute" matter. This additional information will not necessarily be shared as widely as the initial payment data. In lieu of disclosing further information, the IRS may elect to allow disputed amounts to be charged back to the IRS and to reinstate the corresponding tax liability.

Despite the language in most cardholder agreements that permits redisclosure of credit card transaction information, the public may be largely unaware of how widely that information is shared. For example, some financial institutions may share credit, payment, and purchase information with private credit bureaus, who, in turn, may sell this information to direct mail marketers, and others. Without use and redisclosure restrictions, taxpayers may discover that some traditionally confidential tax information might be widely disseminated to direct mail marketers and others.

It is intended that credit or debit card transaction information will generally be restricted to those uses necessary to process payments and resolve billing errors, as well as other purposes that are specified in the statute. The Act directs the Secretary to issue published procedures on what constitutes authorized uses and disclosures. It is anticipated that the Secretary's published procedures will prohibit the use of transaction information for marketing tax-related services by the issuer or any marketing that targets only those who use their credit card to pay their taxes. It is also anticipated that the published procedures will prohibit the sale of transaction information to a third party.

Effective Date

The provision is effective nine months after the date of enactment. The IRS may, in this interim period, conduct internal tests and negotiate with card issuers, but may not accept credit or debit cards for payment of tax liability.

Revenue Effect

The provision is estimated to have a negligible effect on Federal fiscal year budget receipts in each of 1998 through 2007.

B. Provisions Relating to Businesses Generally

1. Modifications to look-back method for long-term contracts (sec. 1211 of the Act and secs. 460 and 167(g) of the Code)

Present and Prior Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Treasury Department) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[290] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

[290] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

Reasons for Change

Prior law may have required multiple applications of the look-back method with respect to a single contract or may have otherwise subjected contracts to the look-back method even though amounts necessitating the look-back calculations were de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicated the mechanics of the look-back calculation. The Congress wished to address these concerns.

Explanation of Provision

Election not to apply the look-back method for de minimis amounts

The Act provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but is not required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.—A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, for Years 1, 2, and 3, respectively, under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The taxpayer may elect to not reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.—A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, for Years 1 through 3, respectively, with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the provision, an electing taxpayer does not apply or reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of cumulative look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of cumulative look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of cumulative look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The Act provides that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The provision applies to contracts completed in taxable years ending after the date of enactment (i.e., after August 5, 1997). The change in the interest rate calculation also applies for purposes of the look-back method applicable to the income forecast method of depreciation for property placed in service after September 13, 1995.

Revenue Effect

The provision is estimated to decrease Federal fiscal year budget receipts by $1 million in 1998, $2 million in 1999, $3 million in 2000, $4 million in 2001, $4 million in 2002, $4 million in 2003, $4 million in 2004, $5 million in 2005, $5 million in 2006, and $5 million in 2007.

2. Minimum tax treatment of certain property and casualty insurance companies (sec. 1212 of the 1997 Act and sec. 56(g)(4)(B) of the Code)

Present and Prior Law

Present and prior law provide that certain property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

All corporations including insurance companies are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).

Reasons for Change

The Congress believed that property and casualty companies small enough to be eligible to simplify their regular tax computation by electing to be taxed only on taxable investment income should be accorded comparable simplicity in the calculation of their alternative minimum tax. Under prior law, the simplicity under the regular tax was nullified because electing companies were required to calculate underwriting income for tax purposes under the alternative minimum tax. The provision thus simplifies the entire Federal income tax calculation for a group of small taxpayers whom Congress has previously determined merit a simpler tax calculation.

Explanation of Provision

The Act provides that a property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company is determined without regard to underwriting income (or underwriting expense, as provided in sec. 56(g)(4)(B)(i)(II)).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998, $2 million in 1999, and $3 million in each of 2000 through 2007.

3. Treatment of construction allowances provided to lessees (sec. 1213 of the bill and new sec. 110 of the Code)

Present and Prior Law

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)).[291] This rule applies whether the lessor or lessee places the leasehold improvements in service.[292] 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 (l)(6)). A lessor of leased property that disposes of a leasehold improvement that 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 (sec. 168(i)(8)).

The gross income of a lessor of real property does not include any amount attributable to the value of buildings erected, or other improvements made by, a lessee that revert to the lessor at the termination of a lease (sec. 109).

Issues have arisen as to the proper treatment of amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to the lease ("construction allowances"). In general, incentive payments are includible in income as accessions to wealth.[293] A coordinated issue paper issued by the Internal Revenue Service ("IRS") on October 7, 1996, states the IRS position that construction allowances generally should be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of the following factors: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates present obligations on the seller to execute and deliver a deed and on the buyer to make payments; (5) whether the

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[291] The Tax Reform Act of 1986 ("1986 Act") 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 denial of component depreciation also applies under MACRS, as provided by the 1986 Act.

[292] 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 1986 Act.

[293] *John B. White, Inc.* v. *Comm.*, 55 T.C. 729 (1971), aff'd per curiam 458 F. 2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972). However, see, e.g., *Federated Department Stores* v. *Comm.,* 51 T.C. 500 (1968) aff'd 426 F. 2d 417 (6th Cir. 1970) and *The May Department Stores Co.* v. *Comm.,* 33 TCM 1128 (1974), aff'd 519 F. 2d 1154 (8th Cir. 1975) with respect to the application of section 118 to certain payments.

right of possession is vested; (6) who pays property taxes; (7) who bears the risk of loss or damage to the property; (8) who receives the profits from the operation and sale of the property; (9) who carries insurance with respect to the property; (10) who is responsible for replacing the property; and (11) who has the benefits of any remainder interests in the property.

Reasons for Change

The Congress understood that it is common industry practice for a lessor to custom improve retail space for the use by a lessee pursuant to a lease. Such leasehold improvements may be provided by the lessor directly constructing the improvements to the lessee's specifications. Alternatively, the lessee may receive a construction allowance from the lessor pursuant to the lease in order for the lessee to build or improve the property. The Congress believed that the tax treatment of lessors and lessees in either case should be the same. The Congress understood that the IRS issue paper reaches a similar conclusion in cases where the lessor is treated as the tax owner of the constructed or improved property. However, the Congress was concerned that the traditional factors cited by the IRS in making the determination of who is the tax owner of the property may be applied differently by the lessor and the lessee and may lead to controversies between the IRS and taxpayers. Thus, the Act provides a safe harbor such that it will be assumed that a construction allowance is used to construct or improve lessor property (and is properly excludible by the lessee) when long-lived property is constructed or improved and used pursuant to a short-term lease. In addition, the Act provides safeguards to ensure that lessors and lessees consistently treat the property subject to the construction allowance as nonresidential real property owned by the lessor.

Explanation of Provision

The Act provides that the gross income of a lessee does not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space. The exclusion only applies to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. For this purpose, "qualified long-term real property" means nonresidential real property that is part of, or otherwise present at, retail space used by the lessee and that reverts to the lessor at the termination of the lease. A "short-term lease" means a lease or other agreement for the occupancy or use of retail space for a term of 15 years or less (as determined pursuant to sec. 168(i)(3)). "Retail space" means real property leased, occupied, or otherwise used by the lessee in its trade or business of selling tangible personal property or services to the general public.

The Act provides that the lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor. However, the lessee's exclusion is not de-

pendent upon the lessor's treatment of the property as nonresidential real property. The present-law rule that allows lessors to take losses with respect to certain leasehold improvements abandoned at the end of the term of the lease (sec. 168(i)(8)) will apply to property treated as owned by the lessor under the Act.

The Act contains reporting requirements to ensure that both the lessor and lessee treat such amounts as nonresidential real property owned by the lessor. Under regulations, the lessor and the lessee shall, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provisions of the Act. It is expected that the Secretary, in promulgating such regulations, will attempt to minimize the administrative burdens of taxpayers while ensuring compliance with the Act.

No inference is intended as to the treatment of amounts that are not subject to the provision, and that the provisions of the IRS issue paper and present and prior law (including case law) will continue to apply where applicable.

Effective Date

The provision applies to leases entered into after the date of enactment (i.e., after August 5, 1997). No inference is intended as to the treatment of amounts that are not subject to the provision.

Revenue Effect

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

C. Partnership Simplification Provisions

1. General provisions

a. Simplified flow-through for electing large partnerships (sec. 1221 of the Act and new secs. 771–777 of the Code)

Present and Prior Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived

from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

Under prior law, the net capital gain of an individual was taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent.[294] Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported.

Deductions and credits

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible only to the extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. The deduction allowed an individual generally cannot exceed 50 percent of the individual's adjusted gross income for the taxable year. The deduction allowed a corporation generally cannot exceed 10 percent of the corporation's taxable income. Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions is separately reported to the partner.

Each partner is allowed his distributive share of credits against his taxable income.

Foreign taxes

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid or accrued with respect to that income. In lieu of elect-

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[294] Section 311 of the 1997 Act, as proposed to be amended by Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997, provides a 28-percent rate for the net capital gain attributable to collectibles, certain gain from small business stock, gains and losses from capital assets held more than one year but not more than 18 months, the net short-term capital loss, and any long-term capital loss carryover. It also provides a 25-percent rate for the net capital gain attribuable to unrecaptured section 1250 depreciation (in the case of section 1231 dispositions, this is limited to the net section 1231 gain), reduced by any net loss from items taken into account in computing the 28-percent gain. It also provides a 20-percent rate on the net capital gain, reduced by the amount of the 28-percent rate gain and the unrecaptured section 1250 depreciation. These provisions generally become effective during 1997. Finally, beginning in 2001 and 2006, it also provides two categories of gain for certain assets held more than five years.

ing the foreign tax credit, a taxpayer may deduct foreign taxes. The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.

Special rules related to oil and gas activities

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners.

A taxpayer who owns an economic interest in a producing deposit of natural resources (including crude oil and natural gas) is permitted to claim a deduction for depletion of the deposit as the minerals are extracted. In the case of oil and gas produced in the United States, a taxpayer generally is permitted to claim the greater of a deduction for cost depletion or percentage depletion. Cost depletion is computed by multiplying a taxpayer's adjusted basis in the depletable property by a fraction, the numerator of which is the amount of current year production from the property and the denominator of which is the property's estimated reserves as of the beginning of that year. Percentage depletion is equal to a specified percentage (generally, 15 percent in the case of oil and gas) of gross income from production. Cost depletion is limited to the taxpayer's basis in the depletable property; percentage depletion is not so limited. Once a taxpayer has exhausted its basis in the depletable property, it may continue to claim percentage depletion deductions (generally referred to as "excess percentage depletion").

Certain limitations apply to the deduction for oil and gas percentage depletion. First, percentage depletion is not available to oil and gas producers who also engage (directly or indirectly) in significant levels of oil and gas retailing or refining activities (so-called "integrated producers" of oil and gas). Second, the deduction for percentage depletion may be claimed by a taxpayer only with respect to up to 1,000 barrels-per-day of production. Third, the percentage depletion deduction may not exceed 100 percent of the taxpayer's net income for the taxable year from the depletable oil and gas property. Fourth, a percentage depletion deduction may not be claimed to the extent that it exceeds 65 percent of the taxpayer's pre-percentage depletion taxable income.

In the case of a partnership that owns depletable oil and gas properties, the depletion allowance is computed separately by the partners and not by the partnership. In computing a partner's

basis in his partnership interest, basis is increased by the partner's share of any partnership-related excess percentage depletion deductions and is decreased (but not below zero) by the partner's total amount of depletion deductions attributable to partnership property.

Intangible drilling and development costs ("IDCs") incurred with respect to domestic oil and gas wells generally may be deducted at the election of the taxpayer. In the case of integrated producers, no more than 70 percent of IDCs incurred during a taxable year may be deducted. IDCs not deducted are capitalized and generally are either added to the property's basis and recovered through depletion deductions or amortized on a straight-line basis over a 60-month period.

The special treatment granted to IDCs incurred in the pursuit of oil and gas may give rise to an item of tax preference or (in the case of corporate taxpayers) an adjusted current earnings ("ACE") adjustment for the alternative minimum tax. The tax preference item is based on a concept of "excess IDCs." In general, excess IDCs are the excess of IDCs deducted for the taxable year over the amount of those IDCs that would have been deducted had they been capitalized and amortized on a straight-line basis over 120 months commencing with the month production begins from the related well. The amount of tax preference is then computed as the difference between the excess IDC amount and 65 percent of the taxpayer's net income from oil and gas (computed without a deduction for excess IDCs). For IDCs incurred in taxable years beginning after 1992, the ACE adjustment related to IDCs is repealed for taxpayers other than integrated producers. Moreover, beginning in 1993, the IDC tax preference generally is repealed for taxpayers other than integrated producers. In this case, however, the repeal of the excess IDC preference may not result in more than a 40 percent reduction (30 percent for taxable years beginning in 1993) in the amount of the taxpayer's alternative minimum taxable income computed as if that preference had not been repealed.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also generally include rental activities (regardless of the taxpayer's material participation).[295] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

[295] An indivdiual who actively participates in rental real estate activity and holds at least a 10-percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the income phaseout range for the $25,000 allowance for rehabilitation credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities.

Income, loss and other items from a publicly traded partnership are treated as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities.

The Omnibus Budget Reconciliation Act of 1993 added a rule, effective for taxable years beginning after December 31, 1993, treating a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which he performs services (sec. 469(c)(7)). Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. An individual taxpayer generally meets the eligibility requirements if (1) more than half of the personal services the taxpayer performs in trades or business during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit ("REMIC"). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("disqualified organizations") multiplied by the highest corporate tax rate.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within seven years of its contribution (sec. 704(c)), or if

other property is distributed to the contributor within the seven year period (sec. 737).

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged (sec. 708).

Reasons for Change

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number of items to each partner. The schedule K–1, on which such items are reported, contains space for more than 40 items. Reporting so many separately stated items is burdensome for individual investors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K–1 against the partner's income tax return. Matching is also difficult because items on the K–1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners by an electing large partnership, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, it is understood that the Internal Revenue Service is considering restricting the use of substitute reporting forms by large partnerships. Reduction of the number of items makes possible a short standardized form.

Explanation of Provisions

In general

The Act modifies the tax treatment of an electing large partnership (generally, any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or

more) and its partners. The provision provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.[296] Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items. For example, special rules may be appropriate to coordinate with the separate rates applicable to capital gains under the 1997 Act.

Under the Act, the taxable income of an electing large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[297] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level.

All elections affecting the computation of taxable income or any credit generally are made by the partnership.

Capital gains

Under the Act, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net capital gain or net capital loss.[298] Such net capital gain or loss is treated as long-term capital gain or loss. Special rules may be appropriate for capital gains or losses that are subject to differing rates of tax.

Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and

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[296] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[297] An electing large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance. No income from an electing large partnership is treated as fishing or farming income.

[298] The term "net capital gain" has the same meaning as in section 1222(11). The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of capital assets. Thus, the partnership cannot offset any portion of capital losses against ordinary income.

other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities. A similar rule applies for purposes of allocating any net capital loss.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The Act contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level;[299] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two-percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the Act. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general

Under the Act, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit, the rehabilitation credit and the credit for producing fuel from a nonconventional source. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credit for clinical testing expenses is subject to the existing limitations on the general business credit. The refundable credit for gasoline used for exempt purposes and the refund or credit for undistributed capital gains of a regulated investment company are allowed to the partnership, and thus are not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[300] In addition, the credit for producing fuel from a nonconventional source is separately reported.

The Act imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the Act, the transfer of an interest in an electing large partnership does not trigger recapture.

Foreign taxes

The Act retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the

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[299] The 70 percent figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

[300] It is understood that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

source of any income, gain, loss or deduction taken into account by the partnership. Elections, computations and limitations are made by the partner.

Tax-exempt interest

The Act retains present-law treatment of tax-exempt interest. Interest on a State or local bond is separately reported to each partner.

Unrelated business taxable income

The Act retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income.

Passive losses

Under the Act, a partner in an electing large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity involving the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c)(5) or (6)) and any rental activity. A partner's share of an electing large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, an electing large partnership generally is not required to separately report items from multiple activities.

A partner in an electing large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

In the case of a partner holding an interest in an electing large partnership which is not a limited partnership interest, such partner's distributive share of any items are taken into account separately to the extent necessary to comply with the passive loss rules. Thus, for example, income of an electing large partnership is not treated as passive income with respect to the general partnership interest of a partner who materially participates in the partnership's trade or business.

Under the Act, the requirement that the passive loss rule be separately applied to each publicly traded partnership (sec. 469(k) of the Code) continues to apply.

Alternative minimum tax

Under the Act, alternative minimum tax ("AMT") adjustments and preferences are combined at the partnership level. An electing large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable

income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. The net AMT adjustment is determined by using the adjustments applicable to individuals (in the case of partners other than corporations), and by using the adjustments applicable to corporations (in the case of corporate partners). Except as provided in regulations, the net AMT adjustment is treated as a deferral preference for purposes of the section 53 minimum tax credit.

Discharge of indebtedness income

If an electing large partnership has income from the discharge of any indebtedness, such income is separately reported to each partner. In addition, the rules governing such income (sec. 108) are applied without regard to the large partnership rules. Partner-level elections under section 108 are made by each partner separately. Thus, for example, the large partnership provisions do not affect section 108(d)(6), which provides that certain section 108 rules apply at the partner level, or section 108(b)(5), which provides for an election to reduce the basis of depreciable property. The large partnership provisions also do not affect the election under 108(c) (added by the Omnibus Budget Reconciliation Act of 1993) to exclude discharge of indebtedness income with respect to qualified real property business indebtedness.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in an electing large partnership are treated as held by disqualified organizations. Thus, an electing large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate. The amount subject to tax is excluded from partnership income.

Election of optional basis adjustments

Under the Act, an electing large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of an electing large partnership's taxable income is made without regard to the section 743(b) adjustment. The section 743(b) adjustment is made only with respect to the transferee partner. In addition, an electing large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner.

Terminations

The Act provides that an electing large partnership does not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

Partnerships and partners subject to large partnership rules

Definition of electing large partnership

An "electing large partnership" is any partnership that elects under the provision, if the number of partners in the preceding tax-

able year is 100 or more. The number of partners is determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) are not counted. Regulations may provide, however, that if the number of partners in any taxable year falls below 100, the partnership may not be treated as an electing large partnership. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Special rules for certain service partnerships

An election under this provision is not effective for any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" does not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Exclusion for commodity partnerships

An election under this provision is not effective for any partnership the principal activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

Special rules for partnerships holding oil and gas properties

Simplified reporting treatment of electing large partnerships with oil and gas activities

The Act provides special rules for electing large partnerships with oil and gas activities that operate under the simplified reporting regime. These partnerships are collectively referred to herein as "oil and gas large partnerships." Generally, the Act provides that an oil and gas large partnership reports information to its partners under the general simplified large partnership reporting regime described above. To prevent the extension of percentage depletion deductions to persons excluded therefrom under present law, however, certain partners are treated as disqualified persons under the Act.

The treatment of a disqualified person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property is determined under the Act without regard to the special rules applicable to large partnerships. Thus, an oil and gas large partnership reports information related to oil and gas activities to a partner who is a disqualified person in the same manner and to the same extent that it reports such information to that partner under present law. The simplified reporting rules of the Act, however, apply with respect to reporting such a partner's share of items not related to oil and gas activities.

The Act defines two categories of taxpayers as disqualified persons. The first category encompasses taxpayers who do not qualify for the deduction for percentage depletion under section 613A (i.e., integrated producers of oil and gas). The second category includes any person whose average daily production of oil and gas (for purposes of determining the depletable oil and natural gas quantity under section 613A(c)(2)) is at least 500 barrels for its taxable year in which (or with which) the partnership's taxable year ends. In making this computation, all production of domestic crude oil and natural gas attributable to the partner is taken into account, including such partner's proportionate share of any production of the large partnership.

A taxpayer that falls within a category of disqualified person has the responsibility of notifying any large partnership in which it holds a direct or indirect interest (e.g., through a pass-through entity) of its status as such. Thus, for example, if an integrated producer owns an interest in a partnership which in turn owns an interest in an oil and gas large partnership, it is responsible for providing the management of the electing large partnership information regarding its status as a disqualified person and details regarding its indirect interest in the electing large partnership.

Under the Act, an oil and gas large partnership computes its deduction for oil and gas depletion under the general statutory rules (subject to certain exceptions described below) under the assumptions that the partnership is the taxpayer and that it qualifies for the percentage depletion deduction. The amount of the depletion deduction, as well as other oil and gas related items, generally are reported to each partner (other than to partners who are disqualified persons) as components of that partner's distributive share of taxable income or loss from passive loss limitation activities. The Act provides that in computing the partnership's oil and gas percentage depletion deduction, the 1,000-barrel-per-day limitation does not apply. In addition, an oil and gas large partnership is allowed to compute percentage depletion under the Act without applying the 65-percent-of-taxable-income limitation under section 613A(d)(1).

An election to deduct IDCs under section 263(c) is made at the partnership level. Since the Act treats those taxpayers required by the Code (sec. 291) to capitalize 30 percent of IDCs as disqualified persons, an oil and gas large partnership may pass through a full deduction of IDCs to its partners who are not disqualified persons. In contrast to prior law, an oil and gas large partnership also has the responsibility with respect to its partners who are not disqualified persons for making an election under section 59(e) to capitalize and amortize certain specified IDCs. Partners who are disqualified persons are permitted to make their own separate section 59(e) elections under the Act.

Consistent with the general reporting regime for electing large partnerships, the Act provides that a single AMT adjustment (under either corporate or non-corporate principles, as the case may be) is made and reported to the partners (other than disqualified persons) of an oil and gas large partnership as a separate item. This separately-reported item is affected by the limitation on the repeal of the tax preference for excess IDCs. For purposes of com-

puting this limitation, the Act treats an oil and gas large partnership as the taxpayer. Thus, the limitation on repeal of the IDC preference is applied at the partnership level and is based on the cumulative reduction in the partnership's alternative minimum taxable income resulting from repeal of that preference.

The Act provides that in making partnership-level computations, any item of income, gain, loss, deduction, or credit attributable to a partner who is a disqualified person is disregarded. For example, in computing the partnership's net income from oil and gas for purposes of determining the IDC preference (if any) to be reported to partners who are not disqualified persons as part of the AMT adjustment, disqualified persons' distributive shares of the partnership's net income from oil and gas are not to be taken into account.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

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

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $6 million in 1998, $8 million per year in each of 1999 through 2002, and $9 million per year in each of 2003 through 2007.

b. Simplified audit procedures for electing large partnerships (sec. 1222 of the Act and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6255, and 6256 of the Code)

Present and Prior Law

In general

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the

IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Change

Audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

The Act creates a new audit system for electing large partnerships. The provision defines "electing large partnership" the same way for audit and reporting purposes (generally, any partnership that elects under the reporting provisions, if the number of partners in the preceding taxable year is 100 or more).

As under prior law, electing large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of "partnership items" are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under prior law.

Unlike prior law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits will be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership).

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $700, apart from any interest or penalty. (The $900 adjustment for the improper deduction would be offset by $200 of adjustments for amortization deductions.) The year 4 partners would be required to include an additional $700 in income for that year. The partnership may ratably amortize the remaining $700 of expenses in years 4–10.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period

beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years' worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

Any payment (for Federal income taxes, interest, or penalties) that an electing large partnership is required to make is nondeductible.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the electing large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS may treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under prior law, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike under prior law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The Act requires each electing large partnership to designate a partner or other person to act on its behalf. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, an electing large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike under prior law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under prior law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed will have jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of an electing large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe regulations as may be necessary to carry out the simplified audit procedure provisions, including regulations to prevent abuse of the provisions through manipulation. The regulations may include rules that address transfers of partnership interests, in anticipation of a partnership adjustment, to persons who are tax-favored (e.g., corporations with net operating losses, tax-exempt organizations, and foreign partners) or persons who are expected to be unable to pay tax (e.g., shell corporations). For example, if prior to the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1997.[301]

[301] A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $500,000 in each of 1998 through 2000, and by $1 million per year for 2001 through 2007.

c. Due date for furnishing information to partners of electing large partnerships (sec. 1223 of the Act and sec. 6031(b) of the Code)

Present and Prior Law

A partnership required to file an income tax return with the Internal Revenue Service must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Reasons for Change

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The Act provides that an electing large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Electing large partnerships are those partnerships subject to the simplified reporting and audit rules (generally, any partnership that elects under the reporting provision, if the number of partners in the preceding taxable year is 100 or more).

The provision also provides that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K–1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.[302]

Revenue Effect

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

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[302] A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

d. Partnership returns required on magnetic media (sec. 1224 of the Act and sec. 6011 of the Code)

Present and Prior Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K–1), to the Internal Revenue Service on magnetic media.

Reasons for Change

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for partnerships to the generally applicable information reporting rules will facilitate intergration of partnership information into already existing data systems.

Explanation of Provision

The Act provides generally that any partnership is required to provide the tax return of the partnership (Form 1065), as well as copies of the schedule sent to each partner (Form K–1), to the Internal Revenue Service on magnetic media. An exception is provided for partnerships with 100 or fewer partners.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.[303]

Revenue Effect

The provision is estimated to have a negligible revenue effect.

e. Treatment of partnership items of individual retirement arrangements (sec. 1225 of the Act and sec. 6012 of the Code)

Present and Prior Law

Return filing requirements

An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year (Treas. Reg. sec. 1.6012–3(a)(5)).

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions

[303] A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

which are directly connected with the carrying on of such trade or business (sec. 512(a)(1). In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000 (sec. 512(b)(12)).

Unified audits of partnerships

All but certain small partnerships are subject to unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

Reasons for Change

Under prior law, tax returns often were required to be filed for IRAs that had no taxable income and, consequently, no tax liability. The filing of these returns by taxpayers, and the processing of these returns by the IRS, impose significant costs. Imposing this burden is unnecessary to the extent that the income of the IRA has been derived from an interest in a partnership that is subject to partnership-level audit rules. In these circumstances, the appropriateness of any deductions may be determined at the partnership level, and an additional filing is unnecessary to facilitate this determination.

Explanation of Provision

The Act modifies the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) is not required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.[304]

Revenue Effect

The provision is estimated to have no revenue effect.

[304] A technical correction may be needed so that the statute reflects this intent. See Title VI of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed by the House on November 5, 1997.

2. Other partnership audit rules

a. Treatment of partnership items in deficiency proceedings (sec. 1231 of the Act and sec. 6234 of the Code)

Present and Prior Law

Partnership proceedings under rules enacted in TEFRA[305] must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in *Munro* v. *Commissioner,* 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in *Munro,* the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Change

The opinion in *Munro* creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceedings are completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there

[305] Tax Equity and Fiscal Responsibility Act of 1982.

would be no deficiency since, under *Munro*, the income must be ignored.

Explanation of Provision

The Act overrules *Munro* and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This eliminates the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the provision provides a special rule to address the factual situation presented in *Munro.*

Specifically, the Act provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS could only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court is granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax is due upon such a determination, but a decision of the Tax Court is treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that is deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS has preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the Act provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the Act incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures do not apply with respect to this increase in tax liability, and

the statute of limitations applicable to TEFRA proceedings are controlling.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

b. Partnership return to be determinative of audit procedures to be followed (sec. 1232 of the Act and sec. 6231 of the Code)

Present and Prior Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The Act permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the provision permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

c. Provisions relating to statute of limitations

i. Suspend statute when an untimely petition is filed (sec. 1233(a) of the Act and sec. 6229 of the Code)

Present and Prior Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect

to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Reasons for Change

Under prior law, if an untimely petition was filed in a TEFRA case, the statute of limitations could expire while the case was still pending before the court. To prevent this from occurring, the IRS must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. These steps are burdensome to the IRS and to taxpayers.

Explanation of Provision

The Act conforms the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the provision, the statute of limitations in TEFRA cases is suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period would no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment (August 5, 1997).

ii. Suspend statute of limitations during bankruptcy proceedings (sec. 1233(b) of the Act and sec. 6229 of the Code)

Present and Prior Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Change

The ambiguity in prior law made it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may have resulted in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The Act clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision does not purport to create any inference as to the proper interpretation of prior law.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment (August 5, 1997).

iii. Extend statute of limitations for bankrupt TMPs (sec. 1233(c) of the Act and sec. 6229 of the Code)

Present and Prior Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)–1T(1)(4) and 301.6231(c)–7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Reasons for Change

The IRS is not automatically notified of bankruptcy filings and cannot easily determine whether a taxpayer is in bankruptcy, especially if the audit of the partnership is being conducted by one district and the taxpayer resides in another district, as is frequently the situation in TEFRA cases. If the IRS does not discover that a person signing a consent is in bankruptcy, the IRS may mistakenly rely on that consent. As a result, the IRS may be precluded from assessing any tax attributable to partnership item adjustments with respect to any of the partners in the partnership.

Explanation of Provision

The Act provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who is the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases are binding on all of the partners in the partnership. The provision is not intended to create any inference as to the proper interpretation of prior law.

Effective Date

The provision is effective for extension agreements entered into after the date of enactment (August 5, 1997).

d. Expansion of small partnership exception (sec. 1234 of the Act and sec. 6231 of the Code)

Present and Prior Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The more existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The Act permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the provision retains the prohibition against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment (August 5, 1997).

e. Exclusion of partial settlements from 1-year limitation on assessment (sec. 1235 of the Act and sec. 6229(f) of the Code)

Present and Prior Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Change

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The Act provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items is determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year is controlling with respect to all disputed partnership items for the partnership taxable year. The provision does not purport to create any inference as to the proper interpretation of prior law.

Effective Date

The provision is effective for settlements entered into after the date of enactment (August 5, 1997).

f. Extension of time for filing a request for administrative adjustment (sec. 1236 of the Act and sec. 6227 of the Code)

Present and Prior Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Change

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The Act provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

g. Availability of innocent spouse relief in context of partnership proceedings (sec. 1237 of the Act and sec. 6230 of the Code)

Present and Prior Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Change

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The Act provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the provision provides that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse could request that the assessment be abated. Upon receipt of such a request, the assessment is abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations does not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court only has jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Alternatively, the Act provides that the spouse of a partner could file a claim for refund to raise the innocent spouse defense. The claim has to be filed within 6 months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed, the spouse could file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

h. Determination of penalties at partnership level (sec. 1238 of the Act and sec. 6221 of the Code)

Present and Prior Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Change

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The Act provides that the partnership-level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the provision allows partners to raise any partner-level defenses in a refund forum.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment (August 5, 1997).

i. Provisions relating to Tax Court jurisdiction (sec. 1239 of the Act and secs. 6225 and 6226 of the Code)

Present and Prior Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Prior law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Change

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The Act clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The provision also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the provision clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment (August 5, 1997).

j. Treatment of premature petitions filed by notice partners or 5-percent groups (sec. 1240 of the Act and sec. 6226 of the Code)

Present and Prior Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are per-

mitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Change

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The Act treats premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that was not available under prior law.

Effective Date

The provision is effective with respect to petitions filed after the date of enactment (August 5, 1997).

k. Bonds in case of appeals from certain proceedings (sec. 1241 of the Act and sec. 7485 of the Code)

Present and Prior Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Change

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The Act clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this provision, the amount of the bond could be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

l. Suspension of interest where delay in computational adjustment resulting from certain settlements (sec. 1242 of the Act and sec. 6601 of the Code)

Present and Prior Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Change

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The Act suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The provision is effective with respect to adjustments relating to taxable years beginning after the date of enactment (August 5, 1997).

m. Special rules for administrative adjustment requests with respect to bad debts or worthless securities (sec. 1243 of the Act and sec. 6227 of the Code)

Present and Prior Law

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) two years from the date the claimed tax was paid, whichever is later (sec. 6511(b)). However, an extended period of time, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (sec. 6511(d)).

Under the TEFRA partnership rules, a request for administrative adjustment ("RAA") must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (sec. 6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment ("FPAA") is mailed for the taxable year (sec. 6227(a)(2)). There is no special provision for extending the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

Reasons for Change

Whether and when a stock or debt becomes worthless is a question of fact that may not be determinable until after the year in which it appears the loss has occurred. An extended statute of limitations allows partners in a TEFRA partnership the same opportunity to file a delayed claim for refund in these difficult factual situations as other taxpayers are permitted.

Further, on past occasions, the IRS issued FPAAs that did not adjust the partnership's tax return. This action created wasteful paperwork, and may have, in some cases truncated the appeals rights of individual partners. A special rule is necessary to permit partners who may have been adversely impacted by this past practice of the IRS to avail themselves of the extended period irrespective of whether an FPAA has been issued.

Explanation of Provision

The Act extends the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in sec. 6227(a)(1), the period for filing an RAA is seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA is still required to be filed before the FPAA is mailed for the taxable year.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

Revenue Effect

The provisions included in item 2 (other partnership audit rules) are estimated to reduce Federal fiscal year budget receipts by $2 million in 1998 and by less than $500,000 per year in each of 1999 through 2007.

3. Closing of partnership taxable year with respect to deceased partner (sec. 1246 of the Act and sec. 706(c)(2)(A) of the Code)

Present and Prior Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See *Estate of Hesse* v. *Commissioner,* 74 T.C. 1307, 1311 (1980).

Reasons for Change

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Prior law closed the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of Provision

The provision provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change prior law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 per year in each of 1998 through 2007.

D. Modifications of Rules for Real Estate Investment Trusts (secs. 1251–1263 of the Act and secs. 856 and 857 of the Code)

Present and Prior Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Election to be treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, under prior law, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of the holding period of their stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or

business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property) such property was not held by the REIT for sale to customers (sec. 856(e)). Under prior law, a property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, sub-

stantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. Under prior law, a REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares. Treasury regulations require that the entity request information from certain shareholders regarding shares directly or indirectly owned by them.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, under prior law, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents from real property

For purposes of the income requirements, rents from real property generally include: (1) rents from interests in real property; (2) charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated; and (3) rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the col-

lection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856–4(b)).

Exclusion of rents from related tenants

Amounts are not treated as qualified rent if they are received from corporate or noncorporate tenants in which the REIT, directly or indirectly, has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)).

Exclusion of rents where services to tenants are performed by related contractors

Where a REIT furnishes or renders services to the tenants, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT (sec. 856(d)(3)(A)), and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)(B)).

Constructive ownership rules involving corporations

For purposes of determining the REIT's ownership interest in a tenant and whether a contractor is independent, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)). Thus, under section 318(a)(2)(C) (as so modified), if 10 or more percent of a REIT or other corporation is owned, directly or indirectly, by or for a person, that person is treated as owning that person's proportionate share of any stock owned directly or indirectly by that corporation.

Constructive ownership rules involving partnerships

Under section 318, stock owned, directly or indirectly, by or for a partnership is considered owned proportionately by its partners (sec. 318(a)(2)(A)). In addition, stock owned, directly or indirectly, by or for a partner is considered owned by the partnership (sec. 318(a)(3)(A)). However, stock constructively owned by a partnership is not considered as owned for purposes of being constructively owned by partners (sec. 318(a)(5)(C)). The following examples illustrate the application of these provisions for purposes of the related tenant and independent contractor rules.

Constructive ownership of tenant

If a REIT owns a 10 percent or greater interest in a person that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT (sec. 856(d)(2)(B)).

Example 1—If 10 percent or more of a REIT's shares are owned by a partnership and a partner owning a one-percent interest in that partnership also owns a 10-percent or greater interest in a person that is a tenant of the REIT, rents paid by the tenant to the REIT are not qualifying rents to the REIT; the 10-percent or greater interest in the tenant is considered owned by the partnership (sec. 318(a)(3)(A)) and in turn by the REIT (secs. 318(a)(3)(C) and 856(d)(5)).

Example 2—If a REIT owns a 30-percent interest in a partnership that in turn owns a 40-percent interest in a person that is a tenant of the REIT, rents paid by that person to the REIT are not qualifying rents to the REIT because the REIT is considered to own more than 10 percent of the tenant (sec. 318(a)(2)(A)).

Example 3—If 10 percent or more of a REIT's shares are owned by persons who are 50-percent partners in a partnership whose other partners own the entirety of the interests in a tenant of the REIT, none of the interests in the tenant are considered owned by the partners who own interests in the REIT (sec. 318(a)(5)(C)).

Constructive ownership of contractor

If a person providing services to tenants of the REIT owns a greater-than-35-percent interest in the REIT, or if another person owns a greater-than-35-percent interest in both the REIT and a person providing services, amounts received or accrued by the REIT with respect to the property are not qualifying rents because the service provider does not qualify as an independent contractor (sec. 856(d)(3)).

Example 4—If more than 35 percent of a REIT's shares are owned by a partnership and a partner owning a one-percent interest in that partnership also owns a greater-than-35-percent interest in a contractor, that person will not be considered an independent contractor because the partnership owns more than 35 percent of the REIT's shares and will also be considered to own a greater-than-35-percent interest in the contractor (sec. 318(a)(3)A)).

Example 5—If more than 35 percent of a REIT's shares are owned by a person who owns a one-percent interest in a partnership and another one-percent partner in that partnership owns more than 35 percent of the interests in a contractor, the independent contractor definition will not be met because the partnership will be considered to own more than 35 percent interests in both the REIT and the contractor (sec. 318 (a)(3)(A)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For

these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income. Excess noncash items include (1) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Explanation of Provisions

Overview

The Act modifies many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Alterative penalty for failure to make requests of shareholders (sec. 1251 of the Act)

The Act replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty is $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

De minimis rule for tenant service income (sec. 1252 of the Act)

The Act permits a REIT to render a *de minimis* amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed one percent of the gross income from the property. For these purposes, the services may not be valued at less than 150 percent of the REIT's direct cost of the services.

Attribution rules applicable to tenant ownership (sec. 1253 of the Act)

The Act modifies the application of the rule attributing ownership from partners to partnerships (sec. 318(a)(3)(A)) for purposes of defining non-qualifying rent from related persons (sec. 856(d)(2)), so that attribution occurs only when a partner owns directly or indirectly a 25-percent or greater interest in the partnership. Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as non-qualifying rents) if the REIT's shares are owned by a partnership and a partner owning a directly and indirectly less-than-25-percent interest in that partnership also owns an interest in the tenant. The related tenant rule (sec. 856(d)(2)(B)) also will not be violated where owners of the REIT and owners of the tenant are partners in a partnership and either the owners of the REIT or the owners of the tenant are directly and indirectly less-than-25-percent partners in the partnership.

In addition, the Act extends, to the definition of an independent contractor under section 856(d)(3), the modification to the attribution to partnerships of section 318(a)(3)(A) so that attribution occurs only when a partner owns a 25-percent or greater interest in the partnership. Thus, a person providing services will not fail to be an independent contractor (and, therefore, amounts received or accrued by the REIT with respect to the property will not be treated as non-qualifying rents) where the REIT's shares are owned by a partnership and a partner owning a directly and indirectly a less-than-25-percent interest in the partnership also owns an interest in a contractor. Similarly, a contractor will not fail to be an independent contractor where owners of the REIT and owners of the contractor are partners in a partnership and either the owners of the REIT or owners of the tenant are directly and indirectly less-than-25-percent partners in the partnership.

Credit for tax paid by REIT on retained capital gains (sec. 1254 of the Act)

The Act permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Repeal of 30-percent gross income requirement (sec. 1255 of the Act)

The Act repeals the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain

real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Modification of earnings and profits for determining whether REIT has earnings and profits from non-REIT year (sec. 1256 of the Act)

The Act changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the Act, distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Treatment of foreclosure property (sec. 1257 of the Act)

The Act lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also can be extended for an additional three years by filing a request to the IRS. A REIT can revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the Act conforms the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Payments under hedging instruments (sec. 1258 of the Act)

The Act treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95-percent test.

Excess noncash income (sec. 1259 of the Act)

The Act (1) expands the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extends the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Prohibited transaction safe harbor (sec. 1260 of the Act)

The Act excludes from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages (sec. 1261 of the Act)

The Act provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the

REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless the REIT acquired the mortgage knew or had reason to know that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Wholly-owned REIT subsidiaries (sec. 1262 of the Act)

The Act permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of sec. 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

Effective Date

The provisions are effective for taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

The provisions are estimated to reduce Federal fiscal year budget receipts by $4 million in 1998, $5 million in both 1999 and 2000, $6 million in 2001, $7 million in both 2002 and 2003, $8 million in 2004, $9 million in 2005, $10 million in 2006, and $11 million in 2007.

E. Repeal of the 30-percent ("Short-Short") Test for Regulated Investment Companies (sec. 1271 of the Act and sec. 851(b)(3) of the Code)

Present and Prior Law

A regulated investment company ("RIC") generally is treated as a conduit for Federal income tax purposes. The Code provides conduit treatment by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income. In order to qualify for conduit treatment, the RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). In particular, under prior law, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than three months (the "short-short test") (sec. 851(b)(3)).

Reasons for Change

The short-short test restricts the investment flexibility of RICs. The test can, for example, limit a RIC's ability to "hedge" its investments (e.g., to use options to protect against adverse market moves).

The test also burdens a RIC with significant recordkeeping, compliance, and administration costs. The RIC must keep track of the holding periods of assets and the relative percentages of short-term gain that it realizes throughout the year. The Congress believed that the short-short test places unnecessary limitations upon a RIC's activities.

Explanation of Provision

The 30-percent test (or short-short test) is repealed.

Effective Date

The provision is effective for taxable years beginning after the date of enactment (after August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $17 million in 1998, $23 million in 1999, $27 million in 2000, $33 million in 2001, $38 million in 2002, $45 million in 2003, $53 million in 2004, $61 million in 2005, $71 million in 2006, and $82 million in 2007.

F. Taxpayer Protections

1. Provide reasonable cause exception for additional penalties (sec. 1281 of the Act and secs. 6652, 6683, and 7519 of the Code)

Present and Prior Law

Many penalties in the Code may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty (sec. 6662) may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith (sec. 6664(c)).

Reasons for Change

The Congress believed that it is appropriate to provide a reasonable cause exception for several additional penalties where one does not currently exist.

Explanation of Provision

The Act provides that the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:

(1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));

(2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));

(3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and

(4) the penalty for failure to make required payments for entities electing not to have the required taxable year (sec. 7519).

Effective Date

The provision was effective for taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

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

2. Clarification of period for filing claims for refunds (sec. 1282 of the Act and sec. 6512 of the Code)

Present and Prior Law

The Code contains a series of limitations on tax refunds. Section 6511 of the Code provides both a limitation on the time period in which a claim for refund can be made (section 6511(a)) and a limitation on the amount that can be allowed as a refund (section 6511(b)). Section 6511(a) provides the general rule that a claim for refund must be filed within 3 years of the date of the return or 2 years of the date of payment of the taxes at issue, whichever is later. Section 6511(b) limits the refund amount that can be covered: if a return was filed, a taxpayer can recover amounts paid within 2 years before the claim. Section 6512(b)(3) incorporates these rules where taxpayers who challenge deficiency notices in Tax Court are found to be entitled to refunds.

In *Commissioner* v. *Lundy*, 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within 3 years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and the 2-year "look back" rule applied. Since over withheld amounts are deemed paid as of the date the taxpayer's return was first due (*i.e.*, more than 2 years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued, and then claimed a refund, the 3-year "look back" rule would apply, and the taxpayer could have obtained a refund of the over withheld amounts.

Reasons for Change

The Congress believed it appropriate to eliminate this disparate treatment.

Explanation of Provision

The Act permits taxpayers who initially fail to file a return, but who receive a notice of deficiency and file suit to contest it in Tax Court during the third year after the return due date, to obtain a refund of excessive amounts paid within the 3-year period prior to the date of the deficiency notice.

Effective Date

The provision applies to claims for refund with respect to taxable years ending after the date of enactment (August 5, 1997).

Revenue Effect

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

3. Repeal of authority to disclose whether a prospective juror has been audited (sec. 1283 of the Act and sec. 6103 of the Code)

Present and Prior Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Reasons for Change

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required, to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Explanation of Provision

The Act repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The provision was effective for judicial proceedings commenced after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to have no revenue effect.

4. Clarify statute of limitations for items from pass-through entities (sec. 1284 of the Act and sec. 6501 of the Code)

Present and Prior Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (*Bufferd* v. *Comm.,* 113 S. Ct. 927 (1993)).

Reasons for Change

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.

Explanation of Provision

The Act clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date

The provision was effective for taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to have no revenue effect.

5. Awarding of administrative costs and attorneys fees (sec. 1285 of the Act and sec. 7430 of the Code)

Present and Prior Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Reasons for Change

The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues and will provide for expedited settlement of these claims.

Explanation of Provision

The Act provides that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The Act also provides that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The Act clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The provision was effective with respect to costs incurred in civil actions or proceedings commenced after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to have no revenue effect.

TITLE XIII. ESTATE, GIFT, AND TRUST SIMPLIFICATION PROVISIONS

1. Eliminate gift tax filing requirements for gifts to charities (sec. 1301 of the Act and sec. 6019 of the Code)

Present and Prior Law

A gift tax generally is imposed on lifetime transfers of property by gift (sec. 2501). In computing the amount of taxable gifts made during a calendar year, a taxpayer generally may deduct the amount of any gifts made to a charity (sec. 2522). Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of certain partial interests in property (such as a remainder interest). A gift of a partial interest in property must be in a prescribed form in order to qualify for the deduction.

Individuals who make gifts in excess of $10,000 to any one donee during the calendar year generally are required to file a gift tax return (sec. 6019). Under prior law, this filing requirement applied to all gifts, whether charitable or noncharitable, and whether or not the gift qualified for a gift tax charitable deduction. Thus, under prior law, a gift tax return was required to be filed for gifts to charity in excess of $10,000, even though no gift tax was payable on the transfer.

Reasons for Change

Because a charitable gift does not give rise to a gift tax liability, many donors were unaware of the requirement to file a gift tax return for charitable gifts in excess of $10,000. Failure to file a gift tax return under these circumstances could have exposed the donor to penalties. The Act eliminated this potential trap for the unwary.

Explanation of Provision

The Act provides that gifts to charity are not subject to the gift tax filing requirements of section 6019, as long as the donor has transferred his entire interest in the property, and the transfer qualifies for the gift tax charitable deduction under section 2522. The filing requirements for gifts of partial interests in property remain unchanged.

Effective Date

The provision is effective for gifts made after the date of enactment (August 5, 1997).

Revenue Effect

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

2. Clarification of waiver of certain rights of recovery (sec. 1302 of the Act and secs. 2207A and 2207B of the Code)

Present and Prior Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). Under prior law, a will provision specifying that all taxes shall be paid by the estate was sufficient to waive the right of recovery.

A decedent's gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). Under prior law, this right could be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Change

It was understood that persons utilizing standard testamentary language often inadvertently waived the right of recovery with respect to QTIP. Similarly, persons waiving a right to contribution were unlikely to refer to the Code section granting the right. Accordingly, the Congress believed that allowing the right of recovery (or right of contribution) to be waived only by specific reference would simplify the drafting of wills by better conforming with the testator's likely intent.

Explanation of Provision

The Act provides that the right of recovery with respect to QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates (e.g., by a specific reference to QTIP, the QTIP trust, section 2044, or section 2207A). Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the right of recovery.

The Act also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedent's will or revocable trust, but specific reference to section 2207B is no longer required.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

3. Transitional rule under section 2056A (sec. 1303 of the Act and sec. 2056A of the Code)

Present and Prior Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees to be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Change

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. Reinstatement of the TAMRA rule for wills drafted in reliance upon it reduces the number of will revisions necessary to comply with statutory changes, thereby simplifying estate planning.

Explanation of Provision

The Act provides that certain trusts created before the enactment of the Omnibus Budget Reconciliation Act of 1990 are treated as satisfying the withholding requirement if the governing instruments require that all trustees be U.S. citizens or domestic corporations.

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

Revenue Effect

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

4. Treatment for estate tax purposes of short-term obligations held by nonresident aliens (sec. 1304 of the Act and sec. 2105 of the Code)

Present and Prior Law

The United States imposes estate tax on assets of noncitizen nondomiciliaries that were situated in the United States at the time of the individual's death. Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States

if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualifies for the bank deposit interest exemption and the portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of these special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. The Tax Reform Act of 1986 amended section 871(h) to address the interaction of the portfolio interest exemption and the treatment of certain interest received by controlled foreign corporations. However, because of this amendment, these special rules no longer covered obligations that generated short-term OID income despite the fact that such income was exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(i)).

Reasons for Change

The Congress believed that the income and estate tax treatments of short-term OID obligations held by nonresident aliens should conform. A purpose of exempting short-term OID income derived by nonresident aliens from U.S. income tax is to enhance the ability of U.S. borrowers to raise funds from foreign lenders, and such purpose would have been hindered by the lack of a corresponding exemption for U.S. estate tax. Moreover, to the extent the interest from such an obligation is exempt from U.S. income tax, the inclusion of the instrument in the nonresident noncitizen's U.S. estate would have been a trap for the unwary.

Explanation of Provision

The Act provides that any debt obligation, the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) if such income were received by the decedent on the date of his death, is treated as property located outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen. No inference is intended with respect to the estate tax treatment of such obligations under prior law.

Effective Date

The provision is effective for estates of decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

5. Certain revocable trusts treated as part of estate (sec. 1305 of the Act and secs. 646 and 2652(b)(1) of the Code)

Present and Prior Law

Both estates and revocable inter vivos trusts can function to settle the affairs of a decedent and distribute assets to heirs. In the case of revocable inter vivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the settlement functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate differently. First, there can be only one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same settlement functions as an estate, but may continue in existence thereafter as testamentary trusts.

Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including: (1) estates are allowed a charitable deduction for amounts *permanently* set aside for charitable purposes while post death revocable trusts are allowed a charitable deduction only for amounts *paid* to charities; (2) the active participation requirement of the passive loss rules under section 469 is waived in the case of estates (but not revocable trusts) for two years after the owner's death; and (3) estates (but not revocable trusts) can qualify for section 194 amortization of reforestation expenditures.

Reasons for Change

The use of revocable trusts may offer certain non-tax advantages for estate planning as compared to a traditional estate plan. There are several differences, however, between the Federal tax treatment of revocable trusts and an estate. These differences may have discouraged individuals from utilizing revocable trusts for estate planning where they might otherwise be appropriate or efficient. Accordingly, in an effort to minimize these tax differences, the Congress believed it was appropriate to allow an election to treat a revocable trust as part of the decedent's estate during a reasonable period of administration.

Explanation of Provision

The Act provides an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for Federal income tax purposes. This elective treatment is effective for taxable years ending after the date of the decedent's death and before the date which is two years after his or her death (if no estate tax return is required) or the date which is six months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor of the decedent's estate (if any) and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its

first taxable year, taking into account any extensions. A conforming change is made to section 2652(b) for generation-skipping transfer tax purposes.

For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated under section 676 as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify).

The separate share rule (described below) generally will apply when a qualified revocable trust is treated as part of the decedent's estate.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million per year for the years 1998 through 2007.

6. Distributions during first 65 days of taxable year of estate (sec. 1306 of the Act and sec. 663(b) of the Code)

Present and Prior Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. Under prior law, the 65-day rule was not applicable to estates.

Reasons for Change

In order to minimize the tax differences between estates and revocable trusts, the Congress believed that the 65-day rule should be allowed to estates as well as to trusts.

Explanation of Provision

The Act extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid by the estate within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Effective Date

The provision applies to taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

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

7. Separate share rules available to estates (sec. 1307 of the Act and sec. 663(c) of the Code)

Present and Prior Law

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus.[306] Treasury regulations provide that "[t]he application of the separate share rule . . . will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. . . . Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist." Treas. Reg. sec. 1.663(c)–3. Under prior law, the separate share rule did not apply to estates.

Reasons for Change

The Congress understood that estates typically do not have separate shares. Nonetheless, where separate shares do exist in an estate, the inapplicability of the separate share rule to estates may result in one beneficiary or class of beneficiaries being taxed on income payable to, or accruing to, a separate beneficiary or class of beneficiaries. Accordingly, the Congress believed that a more equitable taxation of an estate and its beneficiaries would be achieved with the application of the separate share rule to an estate where, under the provisions of the decedent's will or applicable local law, there are separate shares in the estate.

Explanation of Provision

The Act extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are

[306] Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedent's will provides that all of the shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

8. Executor of estate and beneficiaries treated as related persons for disallowance of losses (sec. 1308 of the Act and secs. 267(b) and 1239(b) of the Code)

Present and Prior Law

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For the purposes of section 267, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50 percent owned by the trust or the trust's grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest.

Under prior law, neither section 267 nor section 1239 treated an estate and a beneficiary of the estate as related persons.

Reasons for Change

The Congress believed that the disallowance rules under sections 267 and 1239 with respect to transactions between related parties should apply to an estate and a beneficiary of that estate for the same reasons that such rules apply to a trust and a beneficiary of that trust.

Explanation of Provision

Under the Act, an estate and a beneficiary of that estate are treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Effective Date

The provision applies to taxable years beginning after the date of enactment (August 5, 1997).

Revenue Effect

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

9. Simplified taxation of earnings of pre-need funeral trusts (sec. 1309 of the Act and sec. 684 of the Code)

Present and Prior Law

A pre-need funeral trust is an arrangement where an individual purchases funeral services or merchandise from a funeral home for the benefit of a specified person in advance of that person's death. (The beneficiary may be either the purchaser or another person.) The purchaser enters into a contract with the provider of such services or merchandise whereby the purchaser selects the services or merchandise to be provided upon the death of the beneficiary, and agrees to pay for them in advance of the beneficiary's death. Such amounts (or a portion thereof) are held in trust during the beneficiary's lifetime and are paid to the seller upon the beneficiary's death.

Under prior law, pre-need funeral trusts generally were treated as grantor trusts, and the annual income earned by such trusts was taxed to the purchaser/grantor of the trust. Rev. Rul. 87–127. Any amount received from the trust by the seller (as payment for services or merchandise) is includible in the gross income of the seller.

Reasons for Change

To the extent that pre-need funeral trusts were treated as grantor trusts under prior law, numerous individual taxpayers were required to account for the earnings of such trusts on their tax returns, even though the earnings with respect to any one taxpayer may have been small. The Congress believed that this recordkeeping burden on individuals could be eased, and that compliance with the tax laws would be improved, if such trusts instead were taxed at the entity level, with one simplified annual return filed by the trustee reporting the aggregate income from all such trusts administered by the trustee.

Explanation of Provision

The Act allows the trustee of a pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust is defined as one which meets the following requirements: (1) the trust arises as the result of a contract with a person engaged in the trade or business of providing funeral or burial services or merchandise; (2) the only beneficiaries of the trust are individuals with respect to whom such services or merchandise are to be provided at their death; (3) the only contributions to the trust are contribu-

tions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For this purpose, "contributions" include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $7,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust. Similarly, if the Secretary of the Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $7,000 limit described above, the Secretary may require that such trusts be treated as one trust. For contracts entered into after 1998, the $7,000 limit is indexed annually for inflation.

The trustee's election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchaser's trust. It is anticipated that the Department of the Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. If the election is made, the trust is not treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts (Code sec. 1(e)), but no deduction is allowed under section 642(b). The tax on the annual earnings of the trust is payable by the trustee.

As under prior law, amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller. No gain or loss is recognized to the purchaser of the trust for payments from the trust to the purchaser upon cancellation of the contract, and the purchaser takes a carryover basis in any assets received from the trust upon cancellation.

Effective Date

The provision is effective for taxable years ending after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million per year for the years 1998 through 2007.

10. Adjustments for gifts within 3 years of decedent's death (sec. 1310 of the Act and secs. 2035 and 2038 of the Code)

Present and Prior Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke

the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). There has been significant litigation as to whether these rules require that certain transfers made from a revocable trust within three years of death be includible in the gross estate. See, e.g., *Jalkut Estate* v. *Commissioner*, 96 T.C. 675 (1991) (transfers from revocable trust includible in gross estate); *McNeely* v. *Commissioner*, 16 F.3d 303 (8th Cir. 1994) (transfers from revocable trust not includible in gross estate); *Kisling* v. *Commissioner*, 32 F.3d 1222 (8th Cir. 1994) (acq.) (transfers from revocable trust not includible in gross estate).

Reasons for Change

The inclusion of certain property transferred during the three years before death is directed at transfers that would otherwise reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation between the times of gift and death. Because all amounts transferred from a revocable trust are subject to the gift tax, the Congress believed that inclusion of such amounts was unnecessary where the transferor has retained no power over the property transferred out of the trust. The Congress believed that clarifying these rules statutorily would lend certainty to these rules.

Explanation of Provision

The Act codifies the rule set forth in the *McNeely* and *Kisling* cases to provide that a transfer from a revocable trust (i.e., a trust described under section 676) is treated as if made directly by the grantor. Thus, an annual exclusion gift from such a trust is not included in the gross estate. The provision is not intended to modify the result reached in the Kisling case.

The provision also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

11. Clarify relationship between community property rights and retirement benefits (sec. 1311 of the Act and sec. 2056(b)(7)(C) of the Code)

Present and Prior Law

Community property

Under State community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in either

his or her spouse's qualified plan, individual retirement arrangement ("IRA"), or simplified employee pension ("SEP") plan.

Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 ("REA"), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant generally is permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 ("1986 Act") repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the 1986 Act, the transfer tax treatment of married couples residing in a community property State was unclear where either spouse was covered by a qualified plan.

Reasons for Change

The Congress believed that survivorship interests in annuities in community property States should be accorded similar treatment to the tax treatment of interests in such annuities in non-community property States. Accordingly, the Act clarifies that the transfer at death of a survivorship interest in an annuity to a surviving spouse will be a deductible marital transfer under the QTIP rules regardless of whether the decedent's annuity interest arose out of his or her employment or arose under community property laws by reason of the employment of his or her spouse.

Explanation of Provision

The Act clarifies that the marital deduction is available with respect to a nonparticipant spouse's interest in an annuity attributable to community property laws where he or she predeceases the participant spouse. Under the provision, the nonparticipant spouse's interest in an annuity arising under the community property laws of a State that passes to the surviving participant spouse may qualify for treatment as QTIP under section 2056(b)(7).

The provision is not intended to create an inference regarding the treatment under prior law of a transfer to a surviving spouse of the decedent spouse's interest in an annuity arising under community property laws. The provision is not intended to modify the result of the Supreme Court's decision in *Boggs* v. *Boggs*, 117 S.Ct. 1754 (1997).

Effective Date

The provision applies to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment (August 5, 1997).

Revenue Effect

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

12. Treatment under qualified domestic trust rules of forms of ownership which are not trusts (sec. 1312 of the Act and sec. 2056A(c) of the Code)

Present and Prior Law

A marital deduction generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The marital deduction is not available for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

Trusts are not permitted in some countries (e.g., many civil law countries).[307] As a result, it was not possible under prior law to create a QDT in those countries.

Reasons for Change

The estate of a decedent with a nonresident spouse should not be precluded from qualifying for the marital deduction in situations where the use of a trust is prohibited by another country. Accordingly, the Congress believed it was appropriate to grant regulatory authority to allow qualification for the marital deduction in such situations where the Treasury Department determines that another similar arrangement allows the U.S. to retain jurisdiction and provides adequate security for the payment of U.S. transfer taxes on subsequent transfers by the surviving spouse of the property transferred by the decedent.

Explanation of Provision

The Act provides the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust. It is anticipated that such regulations, if any, would only permit a marital deduction with respect to non-trust arrangements under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. Possible arrangements could include the adoption of a bilateral treaty that provides for the collection of U.S. transfer tax from the noncitizen surviving spouse or a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction and provides adequate security with respect to such transfer taxes.

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[307] Note that in some civil law States (e.g., Louisiana), an entity similar to a trust, called a usufruct, exists.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

13. Opportunity to correct certain failures under section 2032A (sec. 1313 of the Act and sec. 2032A of the Code)

Present and Prior Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

In 1984, section 2032A was amended to provide that if an executor makes a timely election that substantially complies with Treasury regulations, but fails to provide all required information or the signatures of all persons required to enter into the agreement, the executor may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A–8). The administrative policy of the Treasury Department was to disallow current use valuation elections unless the required information was supplied.

Reasons for Change

It was understood that executors commonly fail to include with the filed estate tax return a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. The Congress believed that allowing such signatures or information to be supplied later would be consistent with the legislative intent of section 2032A and would ease return filing.

Explanation of Provision

The Act extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the Treasury regulations. Thus, the Act allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the provision also allows the addition of signatures to a previously filed agreement.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

14. Authority to waive requirement of U.S. trustee for qualified domestic trusts (sec. 1314 of the Act and sec. 2056A(a)(1)(A) of the Code)

Present and Prior Law

In general, in order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts cannot have any U.S. trustees. As a result, trusts established in those countries could not qualify as a QDT under prior law.

Reasons for Change

The estate of a decedent with a nonresident spouse should not be precluded from qualifying for the marital deduction in situations where the use of a U.S. trustee is prohibited by another country. Accordingly, the Congress believed it was appropriate to grant regulatory authority to allow qualification for the marital deduction in such situations where the Treasury Department determines that the U.S. can retain jurisdiction and other adequate security has been provided for the payment of U.S. transfer taxes on subsequent transfers by the surviving spouse of the property transferred by the decedent.

Explanation of Provision

In order to permit the establishment of a QDT in those situations where a country prohibits a trust from having a U.S. trustee, the Act provides the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, provide an alternative mechanism under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent.

Effective Date

The provision applies to decedents dying after the date of enactment (August 5, 1997).

Revenue Effect

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

TITLE XIV. EXCISE TAX AND OTHER SIMPLIFICATION PROVISIONS

A. Excise Tax Simplification Provisions

1. Increase de minimis limit for after-market alterations subject to heavy truck and luxury automobile excise taxes (sec. 1401 of the Act and secs. 4001 and 4051 of the Code)

Present and Prior Law

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight of over 33,000 pounds. The tax is equal to 12 percent of the retail sales price. An excise tax also is imposed on retail sales of luxury automobiles. The tax currently is equal to 8 percent of the amount by which the retail sales price exceeds an inflation-adjusted $30,000 base. (The rate is reduced by 1 percentage point per year through 2002, and the tax is not imposed after 2002.) Anti-abuse rules prevent the avoidance of these taxes through separate purchases of major component parts. With certain exceptions, tax at the rate applicable to the vehicle is imposed on the subsequent installation of parts and accessories within six months after purchase of a taxable vehicle. The exceptions include a de minimis exception for parts and accessories with an aggregate price that does not exceed $200 (or such other amount as Treasury may by regulation prescribe).

Reasons for Change

Retailers generally are responsible for taxes on truck chassis and bodies and luxury automobiles. In the case of a subsequent installation, however, the owner or operator of the vehicle is responsible for paying the tax attributable to the installation and the installer is secondarily liable. Increasing the de minimis amount should significantly reduce the number of return filers and relieve many persons from the administrative burden of filing an excise tax return reporting a very small amount of tax.

Explanation of Provision

The tax on subsequent installation of parts and accessories does not apply to parts and accessories with an aggregate price that does not exceed $1,000.

Effective Date

The increase in the threshold for taxing after-market additions under the heavy truck and luxury car excise taxes is effective for installations on vehicles sold after the date of the Act's enactment (August 5, 1997).

Revenue Effect

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

2. Modify treatment of tires under the heavy highway vehicle retail excise tax (sec. 1402 of the Act and sec. 4052 of the Code)

Present and Prior Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. A separate manufacturers' excise tax is imposed on tires weighing more than 40 pounds. This tire tax is imposed as a fixed dollar amount which varies based on the weight of the tire. Because tires are taxed separately, the value of tires installed on a highway vehicle was excluded from the 12-percent excise tax on heavy highway vehicles under prior law. The determination of value was factual and gave rise to numerous tax audit challenges.

Reasons for Change

The Congress believed that allowing a credit for the tire tax actually paid on truck tires would simplify the application of the retail truck tax.

Explanation of Provision

The prior-law exclusion of the value of tires installed on a taxable highway vehicle is repealed. Instead, a credit for the amount of manufacturers' excise tax actually paid on the tires is allowed.

Effective Date

The provision is effective for sales after December 31, 1997.

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $66 million in 1998, $94 million in 1999, $96 million in 2000, $97 million in 2001, $99 million in 2002, $101 million in 2003, $102 million in 2004, $105 million in 2005, $108 million in 2006, and $110 million in 2007.

3. Simplification of excise taxes on distilled spirits, wine, and beer (secs. 1411–1422 of the Act and secs. 5008, 5053, 5055, 5115, 5175, and 5207, and new secs. 5222 and 5418 of the Code)

Prior Law

Imported distilled spirits returned to plant.—Excise tax that has been paid on domestic distilled spirits is credited or refunded if the spirits are later returned to bonded premises. Under prior law, tax was imposed on imported bottled spirits when they are withdrawn from customs custody, but the tax is not refunded or credited if the spirits are later returned to bonded premises.

Cancellation of export bonds.—An exporter that withdraws distilled spirits from bonded warehouses for export or transportation to a customs bonded warehouse without the payment of tax must furnish a bond to cover the withdrawal. Under prior law, the required bonds were canceled "on the submission of such evidence,

records, and certification indicating exportation as the Secretary may by regulations prescribe."

Location of records of distilled spirits plant.—Proprietors of distilled spirits plants were required to maintain records and reports relating to their production, storage, denaturation, and processing activities on the premises where the operations covered by the record are carried on.

Transfers from brewery to distilled spirits plant.—A distilled spirits plant could receive on its bonded premises beer to be used in the production of distilled spirits only if the beer was produced on contiguous brewery premises.

Sign not required for wholesale dealers.—Wholesale liquor dealers were required to post a sign identifying the firm as such. Failure to do so was subject to a penalty.

Refund on returns of merchantable wine.—Excise tax paid on domestic wine that was returned to bond as unmerchantable was refunded or credited, and the wine was once again treated as wine in bond on the premises of a bonded wine cellar.

Increased sugar limits for certain wine.—Natural wines could be sweetened to correct high acid content. For most wines, however, sugar could not constitute more than 35 percent (by volume) of the combined sugar and juice used to produce the wine. Up to 60 percent sugar could be used in wine made from loganberries, currants, and gooseberries. If the amount of sugar used exceeded the applicable limitation, the wine was required to be labeled "substandard."

Beer withdrawn for embassy use.—Imported beer to be used for the family and official use of representatives of foreign governments or public international organizations may be withdrawn from customs bonded warehouses without payment of excise tax. Under prior law, no similar exemption applied to domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use.

Beer withdrawn for destruction.—Removals of beer from a brewery are exempt from tax if the removal is for export, because the beer is unfit for beverage use, for laboratory analysis, research, development and testing, for the brewer's personal or family use, or as supplies for certain vessels and aircraft.

Drawback on exported beer.—Under prior law, a domestic producer that exports beer could recover the tax (receive a "drawback") found to have been paid on the exported beer upon the "submission of such evidence, records and certificates indicating exportation" required by regulations.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.—Imported beer and wine were subject to tax when removed from customs custody.

Reasons for Change

Until 1980, the method of collecting alcohol excise taxes required the regular presence of Treasury Department inspectors at alcohol production facilities. In 1980, the method of collecting tax was changed to a bonded premises system under which examinations and collection procedures are similar to those used in connection with other Federal excise taxes.

A number of reporting and recordkeeping requirements need to be modified to conform to the current collection system. The Congress determined that appropriate modification will allow the Bureau of Alcohol, Tobacco, and Firearms to administer alcohol excise taxes more efficiently and relieve taxpayers of unnecessary paperwork burdens.

The prior-law rules under which the Code permitted tax-free removals of alcoholic beverages (or allowed a credit or refund of tax on a return to bonded premises) resulted in inappropriate disparities in the treatment of different types of alcoholic beverages. In addition, these rules unduly limited available options for complying with environmental and other laws that regulate the destruction and disposition of alcoholic beverages. Under the bonded premises system, these rules can be liberalized without jeopardizing the collection of tax revenues.

Other provisions of prior law (i.e., the sign requirement and the sugar limits for certain wine) were determined to be outdated and thus appropriately repealed or revised.

Explanation of Provisions

Imported distilled spirits returned to plant.—Refunds or credits of the tax are available for imported bottled spirits that are returned to distilled spirits plants.

Cancellation of export bonds.—The certification requirements are relaxed to allow the bonds to be canceled if there is such proof of exportation as the Secretary may require.

Location of records of distilled spirits plant.—Records and reports are permitted to be maintained elsewhere other than on the plant premises.

Transfers from brewery to distilled spirits plant.—Beer may be brought from any brewery for use in the production of spirits. Such beer is exempt from excise tax, subject to Treasury Department regulations.

Sign not required for wholesale dealers.—The requirement that a sign be posted is repealed.

Refund on returns of merchantable wine.—A refund or credit is available in the case of all domestic wine returned to bond, whether or not unmerchantable.

Increased sugar limits for certain wine.—Up to 60 percent sugar is permitted in any wine made from juice, such as cranberry or plum juice, with an acid content of 20 or more parts per thousand.

Beer withdrawn for embassy use.—Subject to the Treasury Department's regulatory authority, an exemption similar to that currently available for imported beer is provided for domestic beer.

Beer withdrawn for destruction.—An exemption from tax is added for removals for destruction, subject to Treasury regulations.

Drawback on exported beer.—The certification requirement is relaxed to allow a drawback of tax paid if there is such proof of exportation as the Secretary may by regulations require.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.—Subject to Treasury Department regulations, beer and wine imported in bulk may be withdrawn from customs custody and transferred in bulk to a brewery (beer) or a winery (wine) without payment of tax. The proprietor of the

brewery to which the beer is transferred or of the winery to which the wine is transferred is liable for the tax imposed on beer or wine withdrawn from customs custody and the importer is relieved of liability.

Effective Date

The provision to repeal the requirement that wholesale liquor dealers post a sign outside their place of business takes effect on the date of enactment. The other provisions take effect on the first day of the calendar quarter that begins at least 180 days after the date of enactment.

Revenue Effect

The provisions are estimated to have a negligible effect on Federal fiscal year budget receipts.

4. Authority for Internal Revenue Service to grant exemptions from excise tax registration requirements (sec. 1431 of the Act and sec. 4222 of the Code)

Present and Prior Law

The Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for use by a State or local government or a nonprofit educational organization) from certain excise taxes imposed on manufacturers and retailers. These exemptions generally apply only if the seller, the purchaser, and any person to whom the article is resold by the purchaser (the second purchaser) are registered with the Internal Revenue Service. The IRS can waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Reasons for Change

The Congress believed that allowing the Internal Revenue Service to waive the registration requirement for purchasers and second purchasers in all cases would permit more efficient administration of the exemptions and reduce paperwork burdens on taxpayers.

Explanation of Provision

The IRS is authorized to waive the registration requirement for purchasers and second purchasers in all cases.

Effective Date

The provision applies to sales made pursuant to waivers issued after the date of enactment.

Revenue Effect

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

5. Repeal of expired excise tax provisions (sec. 1432 of the Act and secs. 4051, 4495–4498, and 4681–4682 of the Code)

Present and Prior Law

The Code included a provision relating to a temporary reduction in the tax on piggyback trailers sold before July 18, 1985, and provisions relating to the tax on the removal of hard minerals from the deep seabed before June 28, 1990.

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 the 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 was $5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter. The Code contains provisions for special rates of tax applicable to years before 1996 (e.g., sec. 4282(g)(1), (2), (3), and (5)).

Reasons for Change

The Congress believed that the elimination of out-of-date, "deadwood" provisions will simplify the Code by removing unneeded Code sections.

Explanation of Provision

These provisions are repealed, as deadwood.

Effective Date

The provisions were effective on the date of enactment (August 5, 1997).

Revenue Effect

These provisions are estimated to have no effect on Federal fiscal year budget receipts.

6. Modifications to excise tax on certain arrows (sec. 1433 of the Act and sec. 4161 of the Code)

Present and Prior Law

An 11-percent manufacturer's excise tax is imposed on bows having a draw weight of 10 pounds or more, and under prior law on arrows that either were 18 inches or more in length or were suitable for use with a taxable bow. The prior-law tax was imposed on the manufacturer's sales price of the completed arrow.

Reasons for Change

The Congress determined that imposing the excise tax on the component parts of the arrow before they are shipped to the assembler of the arrow will improve compliance with, and collection of, the tax by reducing the potential number of tax collection points.

Explanation of Provision

Under the Act, the prior-law excise tax on arrows is replaced with a manufacturers' excise tax on the four component parts of the arrow: shafts, points, nocks, and vanes. The tax rate is increased to 12.4 percent of the sale price of each of these four components to offset the reduction in aggregate value subjected to tax compared to present-law valuation of the completed arrow.

Effective Date

The provision was effective for arrow components sold after September 30, 1997.

Revenue Effect

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

7. Modifications to heavy highway vehicle retail excise tax (sec. 1434 of the Act and sec. 4051 of the Code)

Present and Prior Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. Small trucks (those with a gross vehicle weight not over 33,000 pounds) and lighter trailers (those with a gross vehicle weight not over 26,000 pounds) are exempt from the tax. The tax applies to the first retail sale of a new or remanufactured vehicle. The determination under present law of whether a particular modification to an existing vehicle constitutes remanufacture (taxable) or a repair (nontaxable) is factual and generally is based on whether the transportation function of the vehicle is changed, the vehicle was wrecked or, in the case of worn vehicles, whether the cost of the modification exceeds 75 percent of the value of the modified vehicle.

No tax is imposed on trucks, tractors, and trailers when they are sold for resale or long-term lease, if the purchaser is registered with the Treasury Department. In such cases, purchasers are liable for the tax when the vehicle is sold or leased. The tax is based on the sales price in the transaction to which it applies.

Reasons for Change

The Congress believed that the 75-percent-of value threshold should apply in determining whether repairs to a wrecked vehicle constitute remanufacture, and that a certification requirement for resales of trucks, tractors, and trailers will simplify administration of the tax.

Explanation of Provision

The Act makes two changes to the heavy vehicle excise tax:

(1) The 75-percent-of-value threshold applies in determining whether repairs to a wrecked vehicle constitute remanufacture; and

(2) The registration requirement currently applicable to certain sales of trucks, tractors, and trailers for resale is replaced with a certification requirement.

Effective Date

The provision is effective after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $5 million in 1998, $8 million per year in 1999, 2000, and 2001, $9 million per year in 2002 and 2003, $10 million per year in 2004 and 2005, and $11 million per year in 2006 and 2007.

8. Treatment of skydiving flights as noncommercial aviation (sec. 1435 of the Act and sec. 4081 and 4261 of the Code)

Present and Prior Law

Under prior law, commercial passenger aviation, or air transportation for which a fare was charged, was subject to a 10-percent ad valorem excise tax for the Airport and Airway Trust Fund.[308] Noncommercial aviation, or air transportation which is not "for hire" is subject to a fuels tax for the Trust Fund. In the case of skydiving flights, questions arose under prior law as to when the flight was commercial aviation subject to the ticket tax and when it was noncommercial aviation subject to the fuels tax. In general, if instruction was offered, the flight was noncommercial aviation. Otherwise, the flight was treated as commercial aviation. Many skydiving flights carry both persons receiving instruction and others not receiving instruction.

Reasons for Change

The Congress believed that the tax treatment of skydiving flights as commercial or noncommercial needed to be clarified.

Explanation of Provision

The Act specifies that flights which are exclusively dedicated to skydiving are taxed as noncommercial aviation flights, regardless of whether instruction is offered to any of the passengers.

Effective Date

The provision was effective for flights beginning after September 30, 1997.

Revenue Effect

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

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[308] The Act, in a separate provision (sec. 1031), modified the tax on commercial aviation and extended all aviation excise taxes for 10 years.

9. Eliminate double taxation of certain aviation fuels sold to producers by "fixed base operators" (sec. 1436 of the Act and sec. 4091 of the Code)

Present and Prior Law

Code section 4091 imposes a tax on the sale of aviation fuel by any producer (defined to include a wholesale distributor). Fuel sold at many rural airports is sold by retail dealers who do not qualify as wholesale distributors. This fuel is purchased by the retailers tax-paid. In certain instances, fuel which has been purchased tax-paid by a retailer will be re-sold to a producer, e.g., to enable the producer to serve one of its customers at the airport. When this fuel is resold at retail by the producer, a second tax may be imposed. Under prior law, the Code contained no provision allowing a refund of the first tax in such cases.

Reasons for Change

The Congress believed that permitting a producer to obtain refund of tax previously paid on aviation fuel that it buys will improve the fairness of the tax collection for such fuel.

Explanation of Provision

The Act permits a producer to obtain a refund of tax previously paid on aviation fuel that the producer buys.

Effective Date

The provision was effective for fuel acquired by a producer after September 30, 1997.

Revenue Effect

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

B. Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private

activity bonds) for the interest on these bonds to be excluded from gross income.

1. Repeal of $100,000 limitation on unspent proceeds under 1-year exception from rebate (sec. 1441 of the Act and sec. 148 of Code)

Present and Prior Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

Under prior law, this six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Change

Exemption of interest paid on State and local bonds from Federal income tax provides an implicit subsidy to State and local governments for their borrowing costs. The principal Federal policy concern underlying the arbitrage rebate requirement is to discourage the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue of governmental and 501(c)(3) bonds is spent within six months, and the remainder is spent within one year, opportunities for such arbitrage profit are significantly limited.

Explanation of Provision

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied.

Effective Date

The provision applies to bonds issued after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1998, $2 million in 1999, $3 million in 2000, $5 million in 2001, $6 million in 2002, $8 million in 2003, $9 million in 2004, $10 million in 2005, $11 million in 2006, and $12 million in 2007.

2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules (sec. 1442 of the Act and sec. 148 of the Code)

Present and Prior Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund under prior law, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

Reasons for Change

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement.

Explanation of Provision

The Act exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

The provision applies to bonds issued after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1998, $1 million in 1999, $2 million in 2000, $3 million in 2001, $3 million in 2002, $4 million in 2003, $5 million in 2004, $6 million in 2005, $6 million in 2006, and $7 million in 2007.

3. Repeal of debt service-based limitation on investment in certain nonpurpose investments (sec. 1443 of the Act and sec. 148 of the Code)

Present and Prior Law

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds to limit arbitrage profits. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield ("yield restrictions"). Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, prior law also limited the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affected primarily investments in reasonably required reserve or replacement funds. Present law and prior law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to ten percent of such proceeds.

The second set of restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government ("arbitrage rebate"). Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Change

The 150-percent of debt service limit was enacted before enactment of the arbitrage rebate requirement and the ten-percent limit on the size of reasonably required reserve or replacement funds. It was intended to eliminate arbitrage-motivated activities available from investment of such reserve funds. Provided that comprehensive yield restriction and arbitrage rebate requirements and the present-law overall size limit on reserve funds are maintained, the 150-percent of debt service yield restriction limit is duplicative.

Explanation of Provision

The Act repeals the 150-percent of debt service yield restriction.

Effective Date

The provision applies to bonds issued after the date of enactment (August 5, 1997).

Revenue Effect

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

4. Repeal of expired provisions relating to student loan bonds (sec. 1444 of the Act and sec. 148 of the Code)

Present and Prior Law

Prior law included two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

Explanation of Provision

These special exceptions are deleted as "deadwood."

Effective Date

The provision applies to bonds issued after the date of enactment (August 5, 1997).

Revenue Effect

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

C. Tax Court Procedures

1. Overpayment determinations of Tax Court (sec. 1451 of the Act and sec. 6512 of the Code)

Present and Prior Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Reasons for Change

Clarification of the jurisdiction of the Tax Court and the ability to appeal orders of the Tax Court would provide for greater certainty for taxpayers and the government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

The Act clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The Act also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $3 million in each of 1998 through 2007.

2. Redetermination of interest pursuant to motion (sec. 1452 of the Act and sec. 7481 of the Code)

Present and Prior Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

Reasons for Change

Congress concluded that it would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Explanation of Provision

The Act provides that a taxpayer must file a "motion" (rather than a 'petition") to seek a redetermination of interest in the Tax Court. The Act also clarifies that the Tax Court's jurisdiction to redetermine the amount of interest under section 7481(c) does not depend on whether the interest is underpayment or overpayment interest. In clarifying the Tax Court's jurisdiction over interest determinations, the Congress did not intend to limit any other remedies that taxpayers may currently have with respect to such determinations, including in particular refund proceedings relating solely to the amount of interest due.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to have no revenue effect.

3. Application of net worth requirement for awards of litigation costs (sec. 1453 of the Act and sec. 7430 of the Code)

Present and Prior Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court pro-

ceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Change

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will provide certainty for potential claimants and will decrease needless litigation over procedural issues.

Explanation of Provision

The Act provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The Act also provides that individuals who file a joint tax return shall be treated as separate individuals for purposes of computing the net worth limitations (resulting in a net worth limitation of $4,000,000 for individuals who file a joint return).

Effective Date

The provision applies to proceedings commenced after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year receipts by $1 million in 1998, $2 million in 1999, $2 million in 2000, $2 million in 2001, $2 million in 2002, $2 million in 2003, $2 million in 2004, $2 million in 2005, $2 million in 2006, and $2 million in 2007.

4. Tax Court jurisdiction for determination of employment status (sec. 1454 of the Act and new sec. 7436 of the Code)

Present and Prior Law

The Tax Court is a court of limited jurisdiction, established under Article I of the Constitution. The Tax Court only has the jurisdiction that is expressly conferred on it by statute (sec. 7442).

Reasons for Change

Congress concluded that it will be advantageous to taxpayers to have the option of going to the Tax Court to resolve certain disputes regarding employment status.

Explanation of Provision

The Act provides that, in connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (1) one or more individuals performing services for that person are employees of that person or (2) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court has jurisdiction to determine whether the IRS is correct. For example, one way the IRS could make the required determination is through a mechanism similar to the employment tax early referral procedures.[309] A failure to agree would also be considered a determination for this purpose, to the extent permitted under Tax Court rules.

The Act provides for de novo review (rather than review of the administrative record). Assessment and collection of the tax attributable to those issues would be suspended while the matter is pending in the Tax Court. Any determination by the Tax Court would have the force and effect of a decision of the Tax Court and would be reviewable as such; accordingly, it would be binding on the parties. Awards of costs and certain fees (pursuant to section 7430) would be available to eligible taxpayers with respect to Tax Court determinations pursuant to this proposal. The Act also provides a number of procedural rules to incorporate this new jurisdiction within the existing procedures applicable in the Tax Court.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

D. Other Provisions

1. Due date for first quarter estimated tax payments by private foundations (sec. 1461 of the Act and sec. 6655(c) of the Code)

Present and Prior Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to two percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940 (as well as any unrelated business income tax liability under section 511).[310] Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15th. Under section 6655(i), foundations with taxable years other than the calendar year must make

[309] See Announcement 96–13 and Announcement 97–52.

[310] Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of (1) the preceding year's tax liability, as shown on the foundation's Form 990–PF, or (2) 95 percent of the foundation's current-year tax liability.

their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

Reasons for Change

Because a private foundation's estimated tax payments are determined, in part, by reference to the foundation's tax liability for the preceding year, Congress concluded that the due date of a foundation's first-quarter estimated tax payment should be the same as the date for filing the foundation's annual return (Form 990-PF) for the preceding year.

Explanation of Provision

The Act amends section 6655(g)(3) to provide that a calendar-year foundation's first-quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990-PF, for the preceding year is due). As a result of the operation of present-law section 6655(i), fiscal-year foundations will be required to make their first-quarter estimated tax payment no later than the 15th day of the fifth month of their taxable year.

Effective Date

The provision applies to taxable years beginning after August 5, 1997, the date of enactment.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, and by less than $500,000 per year in each of 1999 through 2007.

2. Withholding of Commonwealth income taxes from wages of Federal employees (sec. 1462 of the Act and sec. 5517 of Title 5, United States Code)

Present and Prior Law

If State law provides generally for the withholding of State income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of Federal employees in the State. For this purpose, a State is a State, territory, or possession of the United States. The Court of Appeals for the Federal Circuit recently held in *Romero* v. *United States* (38 F.3d 1204 (1994)) that Puerto Rico was not encompassed within this definition; consequently, the court invalidated an agreement between the Secretary of the Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of Federal employees.

Reasons for Change

The Congress believed that employees of the United States should be in no better or worse position than other employees with respect to Commonwealth income tax withholding.

Explanation of Provision

The Act makes any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of Federal employees.

Effective Date

The provision is effective on January 1, 1998.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, $3 million in 1999, $1 million in 2000, $1 million in 2001, $1 million in 2002, $1 million in 2003, $1 million in 2004, $1 million in 2005, $1 million in 2006, and $1 million in 2007.

3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments (sec. 1463 of the Act and sec. 6621 of the Code)

Present and Prior Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

Reasons for Change

The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeded $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment was for an amount less than $100,000. Thus, for example, under prior law, a notice relating to a relatively minor mathematical error by the taxpayer may have resulted in the application of the large corporate underpayment rate to a subsequently identified tax deficiency.

Explanation of Provision

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Effective Date

The provision is effective for purposes of determining interest for periods after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $1 million in 1998, $1 million in 1999, $1 million in 2000, $1 million in 2001, $1 million in 2002, $1 million in 2003, $1 million in 2004, $1 million in 2005, $1 million in 2006, and $1 million in 2007.

TITLE XV. PENSION AND EMPLOYEE BENEFIT PROVISIONS

A. Pension Simplification Provisions

1. Matching contributions of self-employed individuals not treated as elective deferrals (sec. 1501 of the Act and sec. 402(g) of the Code)

Present and Prior Law

Under present and prior law, a qualified cash or deferred arrangement (a "section 401(k) plan") is a type of tax-qualified pension plan under which employees can elect to make pre-tax deferrals. An employee's annual elective deferrals are subject to a dollar limit ($9,500 for 1997). Employers may make matching contributions based on employees' elective deferrals. In the case of employees, such matching contributions are not subject to the $9,500 limit on elective deferrals. Elective deferrals are subject to a special nondiscrimination test, called the average deferral percentage ("ADP") test. Under the ADP test, the maximum amount of elective deferrals that can be made by highly compensated employees is based on the amount of elective deferrals made by nonhighly compensated employees. Matching contributions are subject to a similar nondiscrimination test, called the average contribution percentage ("ACP") test. An employer may treat certain qualified matching contributions as elective deferrals for purposes of satisfying the ADP test.

Under present and prior law, a SIMPLE retirement plan is either an individual retirement arrangement ("IRA") or part of a 401(k) plan that meets certain requirements. Under a SIMPLE retirement plan, employees can elect to make pre-tax deferrals of up to $6,000 per year. Employers are required to make either a matching contribution of up to 3-percent of the employee's compensation or, alternatively, the employer can elect to make a lower percentage contribution on behalf of all eligible employees. Contributions to a SIMPLE retirement plan are not subject to the ADP or ACP tests.

Under prior law, matching contributions made for a self-employed individual were generally treated as additional elective deferrals by the self-employed individual who received the matching contribution. Accordingly, elective deferrals and matching contributions for self-employed individuals were subject to the dollar limits on elective deferrals and, in the case of a 401(k) plan, treated as elective deferrals for purposes of the ADP test.

Reasons for Change

The Congress believed it was appropriate to treat self-employed individuals in the same manner as other employees with regard to the limitations on matching contributions.

Explanation of Provision

The Act provides that matching contributions for self-employed individuals are treated the same as matching contributions for em-

ployees, i.e., they are not subject to the elective deferral limits and are not treated as elective deferrals for purposes of the ADP test (unless the employer elects to treat qualified matching contributions as elective deferrals under the ADP test). The provision does not apply to qualified matching contributions that are treated as elective deferrals for purposes of satisfying the ADP test.

Effective Date

The provision is effective for years beginning after December 31, 1997. In the case of SIMPLE retirement plans (including SIMPLE IRAs and SIMPLE 401(k)s), the provision is effective for years beginning after December 31, 1996.[311]

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for each of years 1998 through 2007.

2. Modification of prohibition on assignment or alienation (sec. 1502 of the Act, sec. 401(a)(13) of the Code, and sec. 206(d) of ERISA)

Present and Prior Law

Under present and prior law, amounts held in a qualified retirement plan for the benefit of a participant are not, except in very limited circumstances, assignable or available to personal creditors of the participant. A plan may permit a participant, at such time as benefits under the plan are in pay status, to make a voluntary revocable assignment of an amount not in excess of 10-percent of any benefit payment, provided the purpose is not to defray plan administration costs. In addition, a plan may comply with a qualified domestic relations order issued by a state court requiring benefit payments to former spouses or other "alternate payees" even if the participant is not in pay status.

Under prior law, there was no specific exception under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or the Internal Revenue Code which would permit the offset of a participant's benefit against the amount owed to a plan by the participant as a result of a breach of fiduciary duty to the plan or criminality involving the plan. Courts were divided in their interpretation of the prohibition on assignment or alienation in these cases. Some courts ruled that there is no exception in ERISA for the offset of a participant's benefit to make a plan whole in the case of a fiduciary breach. Other courts reached a different result and permitted an offset of a participant's benefit for breach of fiduciary duties.

Reasons for Change

The Congress believed that the assignment and alienation rules should be clarified by creating a limited exception that permits par-

[311] A technical correction may be necessary so that the statute reflects this intent with respect to SIMPLE 401(k) plans.

ticipants' benefits under a qualified plan to be reduced under certain circumstances including the participant's breach of fiduciary duty to the plan.

Explanation of Provision

The Act permits a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of ERISA, or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset is required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50-percent survivor annuity for the spouse. An offset is includible in income on the date of the offset (except to the extent attributable to the employee's basis).

Effective Date

The provision is effective for judgments, orders, and degrees issued, and settlement agreements entered into, on or after the date of enactment (August 5, 1997).

Revenue Effect

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

3. Elimination of paperwork burdens on plans (sec. 1503 of the Act and sec. 101 of ERISA)

Present and Prior Law

Under present and prior law, employers are required to prepare summary plan descriptions of employee benefit plans ("SPDs"), and summaries of material modifications to such plans ("SMMs"). The SPDs and SMMs generally provide information concerning the benefits provided by the plan and the participants' rights and obligations under the plan. The SPDs and SMMs must be furnished to plan participants and beneficiaries. Under prior law, SPDs and SMMs had to be filed with the Secretary of Labor.

Reasons for Change

The Congress believed it was appropriate to alleviate the cost and burden of paperwork associated with employee benefit plans.

Explanation of Provision

The Act eliminates the requirement that SPDs and SMMs automatically be filed with the Secretary of Labor. Employers are required to furnish these documents to the Secretary of Labor upon request. A civil penalty may be imposed by the Secretary of Labor on the plan administrator for failure to comply with such requests. The penalty is up to $100 per day of failure, up to a maximum of $1,000 per request. No penalty is imposed if the failure was due to matters reasonably outside the control of the plan administrator.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

4. Modification of section 403(b) exclusion allowance to conform to section 415 modifications (sec. 1504 of the Act and sec. 403(b) of the Code)

Present and Prior Law

Under present and prior law, annual contributions to a section 403(b) annuity cannot exceed the exclusion allowance. In general, the exclusion allowance for a taxable year is the excess, if any, of (1) 20 percent of the employee's includible compensation multiplied by his or her years of service, over (2) the aggregate employer contributions for an annuity excludable for any prior taxable years.

Alternatively, an employee may elect to have the exclusion allowance determined under the rules relating to tax-qualified defined contribution plans (sec. 415). Tax-qualified defined contribution plans are subject to limitations on annual additions. In addition, for years beginning before January 1, 2000, an overall limit applies if an employee is a participant in both a defined contribution plan and defined benefit plan of the same employer (sec. 415(e)).

Reasons for Change

The exclusion allowance for tax-sheltered annuities should be modified to reflect recent changes to the corresponding limits on benefits under tax-qualified plans.

Explanation of Provision

The Act conforms the section 403(b) exclusion allowance to the section 415 limits by providing that includible compensation includes elective deferrals (and similar pre-tax contributions) of the employee.

The Secretary of the Treasury is directed to revise the regulations regarding the election to have the exclusion allowance determined under section 415 to reflect the fact that the overall limit on benefits and contributions is repealed (sec. 415(e)). The revised

regulations are to be effective for years beginning after December 31, 1999.

Effective Date

The modification to the definition of includible compensation is effective for years beginning after December 31, 1997. The direction to the Secretary of the Treasury is effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million per year for each of years 1998 through 2007.

5. Permanent moratorium on application of nondiscrimination rules to State and local governmental plans (sec. 1505 of the Act and secs. 401 and 403(b) of the Code)

Present and Prior Law

Under present and prior law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination and minimum participation rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination rules apply to all governmental plans, qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans). Elective deferrals under section 401(k) plans are required to satisfy a special nondiscrimination test called the average deferral percentage ("ADP") test. Employer matching and after-tax employee contributions are subject to a similar test called the average contribution percentage ("ACP") test.

For purposes of satisfying the nondiscrimination rules, the Internal Revenue Service has issued several Notices which extended the effective date for compliance for governmental plans. Under the Notices, governmental plans will be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

Reasons for Change

The Congress believed that, because of the unique circumstances applicable to governmental plans and the complexity of compliance, the moratorium on compliance with the nondiscrimination rules should be made permanent.

Explanation of Provision

The Act provides that State and local governmental plans are exempt from the nondiscrimination and minimum participation rules. The exemption from the nondiscrimination and participation rules includes exemption from the ADP and ACP tests. A cash or deferred arrangement under a governmental plan is treated as a qualified cash or deferred arrangement even though the ADP test is not in fact satisfied. Thus, for example, elective contributions made by a governmental employer on behalf of an employee are not treated as distributed or made available to the employee (in accordance with section 402(e)(3) of the Code).

Effective Date

The provision is effective for taxable years beginning on and after the date of enactment (August 5, 1997). A governmental plan is treated as satisfying the coverage and nondiscrimination tests for taxable years beginning before the date of enactment.

Revenue Effect

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

6. Clarification of certain rules relating to ESOPs of S corporations (sec. 1506 of the Act and sec. 409 of the Code)

Present and Prior Law

Under present and prior law, an S corporation can have no more than 75 shareholders. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation.

ESOPs are generally required to make distributions in the form of employer securities. If the employer securities are not readily tradable, the employee has a right to require the employer to buy the securities. In the case of an employer whose bylaws or charter restricts ownership of substantially all employer securities to employees or a pension plan, the plan may provide that benefits are distributed in the form of cash. Such a plan may distribute employer securities, if the employee has a right to require the employer to purchase the securities. Under prior law, similar rules did not apply in the case of an ESOP maintained by an S corporation.

ESOPs are subject to certain prohibited transaction rules under the Internal Revenue Code and title I of the Employee Retirement Income Security Act ("ERISA") which are designed to prohibit certain transactions between the plan and certain persons close to the plan. A number of statutory exceptions are provided to the prohibited transaction rules. Under prior law, these statutory exceptions did not apply to any transaction in which a plan (directly or indirectly) (1) lends any part of the assets of the plan to, (2) pays any compensation for personal services rendered to the plan to, or (3) acquires for the plan any property from or sells any property to a shareholder employee of an S corporation, a member of the family of such a shareholder employee, or a corporation controlled by the

shareholder employee. An administrative exception from the prohibited transactions rules may be obtained from the Secretary of Labor, even if a statutory exception does not apply.

Reasons for Change

It is possible that an S corporation may lose its status as such if the ESOP is required to give stock to plan participants, rather than cash equal to the value of the stock. Changes to the prohibited transactions rules are appropriate to facilitate the maintenance of an ESOP by an S corporation.

Explanation of Provision

The Act provides that ESOPs of S corporations may distribute cash to plan participants. Such a plan may distribute employer securities, as long as the employee has a right to require the employer to purchase the securities (as under the rules applicable to ESOPs generally). In addition, the Act provides that the statutory exceptions to the prohibited transaction rules do not fail to apply merely because a transaction involves the sale of employer securities to an ESOP maintained by an S corporation by a shareholder employee, a family member of the shareholder employee, or a corporation controlled by the shareholder employee. Thus, the statutory exemptions for such a transaction (including the exemption for a loan to the ESOP to acquire employer securities in connection with such a sale or a guarantee of such a loan) apply.

Effective Date

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

Revenue Effect

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

7. Modification of 10-percent tax on nondeductible contributions (sec. 1507 of the Act and sec. 4972 of the Code)

Present and Prior Law

Under present and prior law, contributions to qualified pension plans are deductible within certain limits. In the case of a single-employer defined benefit plan which has more than 100 participants during the year, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules. Limits are also imposed on the amount of annual deductible contributions if an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees. Under the combined plan limitation, the total deduction for all plans for a plan year is generally limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit plan for the year.

A 10-percent nondeductible excise tax is imposed on contributions that are not deductible. This excise tax does not apply to contributions to one or more defined contribution plans that are nondeductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed 6 percent of compensation in the year for which the contribution is made.

Reasons for Change

The Congress believed that present law unfairly penalizes employers by imposing an excise tax on employer plan contributions that are required to be made and that are not deductible because the employer is fully funding its pension plan. In particular, the Congress did not believe that the excise tax on nondeductible contributions should be imposed when an employer is required to make contributions attributable to elective deferrals under a section 401(k) plan and employer matching contributions.

Explanation of Provision

The Act adds an additional exception to the 10-percent excise tax on nondeductible contributions. Under the provision, the excise tax does not apply to contributions to one or more defined contribution plans that are not deductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed the amount of the employer's matching contributions plus the elective deferral contributions to a section 401(k) plan for the taxable year for which the contributions are made.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $2 million in 1998, and by $3 million per year in each of 1999 through 2007.

8. Modify funding requirements for certain plans (sec. 1508 of the Act and sec. 412 of the Code)

Present and Prior Law

Under present and prior law, defined benefit pension plans are required to meet certain minimum funding rules. Underfunded plans are required to satisfy certain faster funding requirements. In general, these additional requirements do not apply in the case of plans with a funded current liability percentage of at least 90 percent.

The Pension Benefit Guaranty Corporation ("PBGC") insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

Reasons for Change

Certain interstate bus companies have pension plans that are closed to new participants and the participants in these plans have demonstrated mortality significantly greater than that predicted by the mortality tables that the plans are required to use for minimum funding purposes. As a result, the sponsors of such plans are required to make contributions that cause the plan to be substantially overfunded. The Congress believed it was appropriate to modify the minimum funding requirements for such plans, while at the same time ensuring that pension benefits are adequately funded.

Explanation of Provision

The Act modifies the minimum funding requirements in the case of certain plans. The Act applies in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The provision treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90 percent if the actual funded current liability percentage is at least at certain specified levels.

The relief from the minimum funding requirements applies for the plan year beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

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.

9. Plans not disqualified merely by accepting rollover contributions (sec. 1509 of the Act and sec. 401(a) of the Code)

Present and Prior Law

Under present and prior law, Treasury regulations provide that a qualified retirement plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified. The receiving plan can reasonably conclude that the distributing plan was qualified if,

for example, prior to accepting the rollover, the distributing plan provided a statement that the distributing plan had a favorable determination letter issued by the Internal Revenue Service ("IRS"). The receiving plan is not required to verify this information.

Reasons for Change

In order to encourage employers to accept rollovers from other qualified retirement plans, the Congress believed that the receiving plans should be insulated from disqualification based on the subsequent qualified status of the distributing plan.

Explanation of Provision

The Act directs the Secretary of the Treasury to clarify that, under its regulations protecting plans from disqualification because they receive invalid rollover contributions, it is not necessary for a distributing plan to have a determination letter in order for the administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

10. New technologies in retirement plans (sec. 1510 of the Act)

Prior Law

Under prior law, it was not clear if sponsors of employee benefit plans could use new technologies (telephonic response systems, computers, email) to satisfy the various ERISA requirements for notice, election, consent, record keeping, and participant disclosure.

Reasons for Change

The Congress believed it was appropriate to review existing guidance for purposes of permitting the use of new technologies for notice and record keeping requirements for retirement plans.

Explanation of Provision

The Act directs the Secretaries of the Treasury and Labor to issue guidance facilitating the use of new technology for plan purposes. The guidance must be designed to (1) interpret the notice, election, consent, disclosure, and time requirements (and related recordkeeping requirements) under the Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act of 1974, as amended ("ERISA") relating to retirement plans as applied to the use of new technologies by plan sponsors and administrators while maintaining the protection of the rights of participants and beneficiaries, and (2) clarify the extent to which writing require-

ments under the Code will be interpreted to permit paperless transactions.

Effective Date

The provision was effective on the date of enactment (August 5, 1997), and requires that the guidance be issued not later than December 31, 1998.

Revenue Effect

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

B. Miscellaneous Provisions Relating to Pensions and Other Benefits

1. Increase in full funding limit (sec. 1521 of the Act and sec. 412 of the Code)

Present and Prior Law

Under present and prior law, defined benefit pension plans are subject to minimum funding requirements. In addition, there is a maximum limit on contributions that can be made to a plan, called the full funding limit. Under prior law, the full funding limit was generally the lesser of a plan's accrued liability and 150 percent of current liability. In general, current liability is all liabilities to plan participants and beneficiaries. Current liability represents benefits accrued to date, whereas the accrued liability full funding limit is based on projected benefits. Under IRS rules, amounts that cannot be contributed because of the current liability full funding limit are amortized over 10 years.

Reasons for Change

The 150-percent of full funding limit was enacted to limit and allocate efficiently the Federal tax revenue associated with the special tax treatment provided to tax-qualified plans. However, the Congress believed that the 150-percent of current liability full funding limit unduly restricts funding and that the amortization period should be extended.

Explanation of Provision

The Act increases the 150-percent of current liability full funding limit as follows: 155 percent for plan years beginning in 1999 or 2000, 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter. In addition, amounts that cannot be contributed due to the current liability full funding limit are amortized over 20 years. Amounts that could not be contributed because of the prior-law current liability full funding limit and that have not been amortized as of the last day of the last plan year beginning in 1998 are amortized over this 20-year period. With respect to amortization bases remaining at the end of the 1998 plan year, the 20-year amortization period is reduced by the number of years since the amortization base had been estab-

lished. No amortization is required with respect to funding methods that do not provide for amortization bases.

Effective Date

The provision is effective for plan years beginning after December 31, 1998.

Revenue Effect

The provision is estimated is estimated to reduce Federal fiscal year budget receipts by $4 million in 1999, $12 million in 2000, $14 million in 2001, $18 million in 2002, $19 million in 2003, $23 million per year for 2004 and 2005, and $25 million per year for 2006 and 2007.

2. Contributions on behalf of a minister to a church plan (sec. 1522(a)(2) of the Act and sec. 414(e) of the Code)

Present and Prior Law

Under present and prior law, contributions made to retirement plans by ministers who are self-employed are deductible to the extent such contributions do not exceed certain limitations applicable to retirement plans. These limitations include the limit on elective deferrals, the exclusion allowance, and the limit on annual additions to a retirement plan.

Reasons for Change

The Congress believed that the unique characteristics of church plans and the procedures associated with contributions made by ministers who are self-employed create particular problems with respect to plan administration.

Explanation of Provision

The Act provides that in the case of a contribution made to a church plan on behalf of a minister who is self-employed, the contribution is excludable from the income of the minister to the extent that the contribution would be excludable if the minister was an employee of a church and the contribution was made to the plan. The provision does not alter present law under which amounts contributed for a minister in connection with section 403(b), either by the minister's actual employer or by any church or convention or association of churches that is treated as the minister's employer under section 414(e), are excluded from the minister's income, and amounts contributed in accordance with section 403(b) by the minister (whether the minister is an employee or is self-employed) are deductible by the minister as provided in section 404 taking into account the other special rules of section 414(e). A minister will not be entitled to both an exclusion and deduction for the same contribution.

Effective Date

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

Revenue Effect

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

3. Exclusion of ministers from discrimination testing of certain non-church retirement plans (sec. 1522(a)(1) of the Act and sec. 414(e) of the Code)

Present and Prior Law

Under present and prior law ministers who are employed by an organization other than a church are treated as if employed by the church and may participate in the retirement plan sponsored by the church. Under prior law, if the organization also sponsored a retirement plan, such plan did not have to include the ministers as employees for purposes of satisfying the nondiscrimination rules applicable to qualified plans provided the organization was not eligible to participate in the church plan.

Reasons for Change

The Congress believed it was appropriate to extend the same relief to other non-church organizations that may be eligible to participate in a church plan but elect not to do so. Such organizations will not be required to treat ministers as employees for purposes of satisfying the nondiscrimination rules applicable to their retirement plan.

Explanation of Provision

The Act provides that if a minister is employed by an organization other than a church and the organization is not otherwise participating in the church plan, then the minister does not have to be included as an employee under the retirement plan of the organization for purposes of the nondiscrimination rules.

Effective Date

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

Revenue Effect

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

4. Repeal application of UBIT to ESOPs of S corporations (sec. 1523 of the Act and sec. 512 of the Code)

Present and Prior Law

Under present and prior law, for taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation. Under prior law, items of income or loss of the S corporation flowed through to all qualified tax-exempt shareholders as unrelated business taxable income ("UBTI"), regardless of the source of the income.

Reasons for Change

The Congress believed that treating S corporation income as UBTI is not appropriate because such amounts would be subject to tax at the ESOP level, and also again when benefits are distributed to ESOP participants.

Explanation of Provision

The Act repeals the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder. The repeal of such provision applies only with respect to employer securities held by an employee stock ownership plan (as defined in section 4975(e)(7) of the Code) maintained by an S corporation.

Effective Date

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

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1998, $23 million in 1999, $34 million in 2000, $41 million in 2001, $44 million in 2002, $46 million in 2003, $48 million in 2004, $50 million in 2005, $52 million in 2006, and $54 million in 2007.

5. Diversification in section 401(k) plan investments (sec. 1524 of the Act and sec. 407(b) of ERISA)

Present and Prior Law

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10 percent of the fair market value of plan assets. Under prior law, the 10-percent limitation did not apply to any "eligible individual account plans" that specifically authorized such investments. Generally, eligible individual account plans were defined contribution plans, including plans containing a cash or deferred arrangement ("401(k) plans"). Under prior law, the assets of such plans could be invested in employer securities and real property without regard to the 10-percent limitation.

Reasons for Change

Because of the growth of 401(k) plans in recent years and the fact that these plans serve as a significant source of pension benefits for many individuals, the Congress was concerned with protecting and preserving these benefits. Requiring participant contributions to be invested in employer securities or real property could have an adverse impact on the retirement security of the plan participants. In circumstances where an employer experiences finan-

cial distress, including bankruptcy, participants would be affected by a decrease in the value of employer securities and real property.

Explanation of Provision

The Act provides that the term "eligible individual account plan" does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1 percent of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10-percent limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The provision does not apply if individual account plans are a small part of the employer's retirement plans. In particular, the provision does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10 percent of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10 percent of the value of the assets of all pension plans maintained by the employer. The provision does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

In determining whether individual account plans are a small part of the employer's total pension plan assets, all assets of such plans (regardless of when acquired) are taken into account. Similarly, if the provision applies to the portion of a plan consisting of elective deferrals and earnings thereon (so that such portion of a plan is subject to the 10-percent limitation on employer securities and real property), all assets of such portion of the plan (regardless of when acquired) are taken into account in determining whether the 10-percent limitation is violated.

The effect of the provision is illustrated as follows. Assume the provision applies to the portion of a plan consisting of elective deferrals (and earnings thereon), so that such portion of a plan is treated as a separate plan subject to the 10-percent limitation on employer securities and real property, and that more than 10-percent of such separate plan's assets are invested in employer securities. The separate plan cannot acquire more employer securities or real property, unless the participants elect such investment.

Effective Date

The provision is effective with respect to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). The provision does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

Revenue Effect

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

6. Cash or deferred arrangements for irrigation and drainage entities (sec. 1525 of the Act and sec. 401(k) of the Code)

Present and Prior Law

Under present and prior law, taxable and tax-exempt employers may maintain qualified cash or deferred arrangements. Under prior law, all State and local government organizations generally were prohibited from maintaining qualified cash or deferred arrangements ("section 401(k) plans"), other than qualified cash or deferred arrangements adopted by a State or local government before May 6, 1986.

Mutual irrigation or ditch companies are exempt from tax if at least 85 percent of the income of the company consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Reasons for Change

The Congress believed that all mutual irrigation and ditch companies and water districts should be permitted to maintain a qualified cash or deferred arrangement, regardless of whether the company or district is a tax-exempt or taxable entity or part of a State or local government.

Explanation of Provision

Under the Act, mutual irrigation or ditch companies and districts organized under the laws of a State as a municipal corporation for the purpose of irrigation, water conservation or drainage (or a national association of such organizations) are permitted to maintain qualified cash or deferred arrangements, even if the company or district is a State or local government organization.

Effective Date

The provision is effective with respect to years beginning after December 31, 1997.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $1 million in 1998, $1 million per year in each of 1999 through 2001, $2 million per year in each of 2002 through 2006, and $3 million in 2007.

7. Portability of permissive service credit under governmental pension plans (sec. 1526 of the Act and sec. 415 of the Code)

Present and Prior Law

Under present and prior law, limits are imposed on the contributions and benefits under qualified pension plans (Code sec. 415).

In the case of a defined contribution plan, the limit on annual additions is the lesser of $30,000 or 25 percent of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $120,000 (indexed for inflation). The 100 percent of compensation limitation does not apply in the case of State and local governmental pension plans. Certain other special rules apply in the case of State and local governmental plans.

Amounts contributed by employees to a State or local governmental plan are treated as made by the employer if the employer "picks up" the contribution.

Under prior law, there were no special rules applicable to make-up contributions by State and local government employees.

Reasons for Change

Many State and local government plans facilitate portability of pension benefits by permitting employees to purchase credit for service with another governmental employer and for certain other service as provided in the plan. The Congress believed it was appropriate to modify the limits on contributions and benefits to encourage portability of benefits between governmental plans.

Explanation of Provision

Under the Act, contributions by a participant in a State or local governmental plan to purchase permissive service credits are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the $30,000 limit on annual additions is met for the year (taking into account any other annual additions of the participant). Under the first alternative, a plan will not fail to satisfy the reduced defined benefit pension plan limit that applies in the case of early retirement due to the accrued benefit derived from the purchase of permissive service credits. These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Under the Act, permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the

plan. Section 415 is violated if more than 5 years of permissive service credit is purchased for "nonqualified service". In addition, section 415 is violated if nonqualified service is taken into account for an employee who has less than 5 years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, State, or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

The Act provides that in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State) any such repayment shall not be taken into account for purposes of section 415 and service credit obtained as a result of the repayment shall not be considered permissive service credit.

The provision is not intended to affect the application of "pick up" contributions to purchase permissive service credit or the treatment of pick up contributions under section 415. The provision does not apply to purchases of service credit for qualified military service under the rules relating to veterans' reemployment rights (sec. 414(u)).

Effective Date

The provision is effective with respect to contributions to purchase permissive service credits made in years beginning after December 31, 1997.

The Act provides a transition rule for plans that provided for the purchase of permissive service credit prior to enactment of the Act. Under this rule, the defined contribution limits will not reduce the amount of permissive service credit of an eligible participant allowed under the terms of the plan as in effect on the date of enactment. For this purpose an eligible participant is an individual who first became a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of the enactment of this Act) of the governing body with authority to amend the plan ends.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $9 million in 1998, $25 million per year in each of years 1999 and 2000, $26 million per year in each of years 2001 through 2003, $27 million per year in each of years 2004 through 2006, and $28 million in 2007.

8. Removal of dollar limitation on benefit payments from a defined benefit plan for police and fire employees (sec. 1527 of the Act and sec. 415(b)(2) of the Code)

Present and Prior Law

Under present and prior law, limits are imposed on the contributions and benefits under qualified pension plans. Certain special rules apply in the case of State and local governmental plans.

In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $125,000 (for 1997, indexed for inflation). The 100 percent of compensation limitation does not apply in the case of State and local governmental pension plans. In general, the dollar limit is reduced if benefits begin before social security retirement age and increased if benefits begin after social security retirement age. In the case of State and local government plans, the dollar limit is not reduced unless benefits begin before age 62 and in any case is not less than $75,000, and the dollar limit is increased if benefits begin after age 65. Under prior law, this rule applied to police and fire department employees, except that the dollar limit could not be reduced below $50,000 (indexed), regardless of the age at which benefits commenced.[312]

Reasons for Change

The Congress believed that police and fire department employees who are covered by the special rule should be excepted from the dollar limit as it applies to the reduction for early retirement benefits.

Explanation of Provision

The dollar limit on defined benefit plans does not apply to the reduction for early retirement benefits for individuals who received the special rule for certain police and fire department employees under prior law. Thus, the defined benefit plan dollar limit continues to apply, but is not reduced in the case of early retirement. As under present law, the dollar limit is increased for such employees if benefits begin after age 65.

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.

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[312] This special rule applied to participants (1) in a defined benefit plan of a State or local government plan, and (2) with respect to whom the period of service taken into account in determining the amount of the benefit under such plan includes at least 15 years of service of the participant as (a) a full-time employee of a police or fire department organized by a State or political subdivision to provide police protection, firefighting services, or emergency medical services or (b) as a member of the Armed Services of the United States.

9. Survivor benefits of public safety officers killed in the line of duty (sec. 1528 of the Act and sec. 101 of the Code)

Present and Prior Law

Under present and prior law, survivors of military service personnel (such as those killed in combat) are generally entitled to survivor benefits (38 U.S.C. sec. 1310). These survivor benefits are generally exempt from taxation (38 U.S.C. sec. 5301). "Survivor" means the surviving spouse or surviving dependent child of the military service personnel.

Under prior law, survivor annuity benefits paid under a governmental retirement plan to a survivor of a law enforcement officer killed in the line of duty were generally includible in income except to the extent the benefits are a return of after-tax employee contributions. Under present and prior law, survivor benefits paid under a government plan only to survivors of officers who died as a result of injuries sustained in the line of duty are in the nature of workers' compensation and are generally excludable from income.

Reasons for Change

The Congress believed that it was appropriate to apply to the survivors of public safety officers who are killed in the line of duty the rules regarding the taxation of certain survivor benefits provided to survivors of military personnel.

Explanation of Provision

The Act generally provides that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The provision does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer.

Effective Date

The provision applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by less than $500,000 in 1998, $1 million per year in each of 1999 through 2005, and by $2 million per year in each of 2006 and 2007.

10. Treatment of certain disability payments to public safety employees (sec. 1529 of the Act and sec. 104 of the Code)

Present and Prior Law

Under present and prior law, amounts received under a workmen's compensation act as compensation for personal injuries or sickness incurred in the course of employment are excluded from gross income. Compensation received under a workmen's compensation act by the survivors of a deceased employee also are excluded from gross income. Under prior law, no nonoccupational death and disability benefits were excludable from income as workmen's compensation benefits.

Reasons for Change

The Congress was aware that some State plans were structured so that the exclusion for workers' compensation benefits was not applicable, and that some benefit recipients mistakenly thought the exclusion applied. The Congress believed it was appropriate to provide relief in such cases.

Explanation of Provision

Under the Act, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a State (or any political subdivision, agency, or instrumentality thereof) are excludable from income. The provision applies to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, 1991 pursuant to a State law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses, but only for employees separating from service before July 1, 1992.

The Act provides that claims for refund or credit for overpayment of tax resulting from the provision could be filed up to 1 year after the date of enactment, without regard to the otherwise applicable statute of limitations.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $10 million in 1998, and by $1 million in 1999.

11. Gratuitous transfers for the benefit of employees (sec. 1530 of the Act and sec. 664 of the Code)

Present and Prior Law

Under present and prior law, an employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer securities are held for the benefit of employees.

Under present and prior law, a deduction is allowed for Federal estate tax purposes for transfers by a decedent to charitable, religious, scientific, etc. organizations. In the case of a transfer of a remainder interest to a charity, the remainder interest must be in a charitable remainder trust. A charitable remainder trust generally is a trust that is required to pay, no less often than annually, a fixed dollar amount (charitable remainder annuity trust) or a fixed percentage of the fair market value of the trust's assets determined at least annually (charitable remainder unitrust) to noncharitable beneficiaries, and, under prior law, the remainder of the trust (i.e., after termination of the annuity or unitrust amounts) to a charitable, religious, scientific, etc. organization.

Reasons for Change

The Congress believed it was appropriate to encourage certain transfers of stock to an ESOP.

Explanation of Provision

In general

The Act permits certain limited transfers of qualified employer securities by charitable remainder trusts to ESOPs without adversely affecting the status of the charitable remainder trusts under Code section 664. As a result, the Act provides that a qualified gratuitous transfer of employer securities to an ESOP is deductible from the gross estate of a decedent under Code section 2055 to the extent of the present value of the remainder interest. In addition, an ESOP will not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

Qualified gratuitous transfer

In order for a transfer of securities to be a "qualified gratuitous transfer," the following requirements must be satisfied, including the following: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members of the decedent own (directly or indirectly) no more than 10 percent of the value of the outstanding stock of the company; (3) immediately after the transfer to the ESOP, the ESOP owns at least 60 percent[313] of the value of outstanding stock of the company; and (4) the plan meets certain requirements. In order to prevent erosion of the 60-percent ownership requirements, an excise tax is im-

[313] The 60-percent requirement is determined assuming that outstanding options have been exercised.

posed on the employer maintaining the ESOP with respect to certain dispositions of the transferred stock within 3 years of the transfer.

The provision applies in cases in which the ESOP was in existence on August 1, 1996, and the decedent dies on or before December 31, 1998. The provision does not fail to apply merely because the ESOP is amended after August 1, 1996, for example, in order to conform to the requirements of the provision.

Plan requirements

In order for a transfer to qualify as a gratuitous transfer, the ESOP must contain certain provisions. First, the plan must provide that plan participants are entitled to direct the manner in which stock transferred are to be voted (with respect to all matters). Transferred securities that have not yet been allocated to participants must be voted by a trustee that is not a 5-percent owner of the company or a family member of the decedent.

Second, the plan must provide that participants have the right to receive distributions in the form of stock and that the participant can require the employer to repurchase any shares distributed under a fair valuation formula. For this purpose, a valuation formula is not considered fair if it takes into account a discount for minority interests.

Finally, the plan must provide that, if the plan is terminated before all the transferred stock has been allocated, the remaining stock is to be transferred to one or more charitable organizations. The employer is subject to an excise tax designed to recapture the estate taxes that would have been due had the transfer to the ESOP not occurred if the plan is terminated and any unallocated shares are not transferred to charitable organizations.

Treatment of transferred stock and allocation rules

No deduction is permitted under section 404 of the Code with respect to securities transferred from the charitable remainder trust. The nondiscrimination requirements (sec. 401(a)(4)) normally applicable to qualified plans must be satisfied with respect to the securities transferred. The ESOP is required to treat the securities transferred as employer securities, except for purposes of determining the amount of deductible contributions to the plan otherwise permitted by the employer. The ESOP is required to allocate the transferred securities up to the limit on contributions and benefits (sec. 415) after allocating any other employer contributions for the year; any transferred securities that cannot be allocated because of the section 415 limits would be held in a suspense account and allocated in the same manner in subsequent years. Transferred securities are not taken into account in determining whether any other contributions satisfy the section 415 limit. Further, securities transferred to an ESOP by a charitable remainder trust cannot be allocated to the account of (1) any family member of the decedent, or (2) any employee owning more than 5 percent of any class of outstanding stock of the corporation issuing the securities (or a member of a controlled group of corporations) or the total value of any class of outstanding stock of any such corporation. The employer is subject to an excise tax if impermissible allocations are made.

Definition of qualified employer securities

Qualified employer securities include only employer securities (within the meaning of sec. 409(l) of the Code), which are issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market and that has only one class of stock.

Effective Date

The provision was effective with respect to transfers to an ESOP after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to reduce Federal fiscal year budget receipts by $8 million in 1998 and by $15 million in 1999.

C. Certain Health Act Provisions

1. Newborns' and mothers' health protection; mental health parity (sec. 1531 of the Act)

Present and Prior Law

The Newborns' and Mothers' Health Protection Act of 1996 amended the Employee Retirement Income Security Act ("ERISA") and the Public Health Service Act to impose certain requirements on group health plans with respect to coverage of newborns and mothers, including a requirement that a group health plan cannot restrict benefits for a hospital stay in connection with childbirth for the mother or newborn to less than 48 hours following a normal vaginal delivery or less than 96 hours following a cesarean section. These provisions are effective with respect to plan years beginning on or after January 1, 1998.

The Mental Health Parity Act of 1996 amended ERISA and the Public Health Service Act to provide that group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits. The provisions of the Mental Health Parity Act are effective with respect to plan years beginning on or after January 1, 1998, but do not apply to benefits for services furnished on or after September 30, 2001.

The Internal Revenue Code requires that group health plans meet certain requirements with respect to limitations on exclusions of preexisting conditions and that group health plans not discriminate against individuals based on health status. An excise tax of $100 per day during the period of noncompliance is imposed on the employer sponsoring the plan if the plan fails to meet these requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer's group health plan expenses for the prior year or $500,000. No tax is imposed if the Secretary determines that the employer did not know, and exercising reasonable diligence would not have known, that the failure existed.

Under prior law, the provisions of the Newborns' and Mothers' Health Protection Act and the Mental Health Parity Act were not in the Code.

Explanation of Provision

The Act incorporates into the Internal Revenue Code the provisions of the Newborns' and Mothers' Health Protection Act of 1996 and the Mental Health Parity Act of 1996 relating to group health plans. Failures to comply with such provisions are subject to the excise tax applicable to failures to comply with present-law group health plan requirements.

Effective Date

The provisions are effective with respect to plan years beginning on or after January 1, 1998. However, the provisions relating to the Mental Health Parity Act do not apply to benefits for services furnished on or after September 30, 2001.

Revenue Effect

The provisions are estimated to have a negligible effect on Federal fiscal year budget receipts.

2. Church plan exception to prohibition on discrimination against individuals based on health status (sec. 1532 of the Act)

Present and Prior Law

Under the Health Insurance Portability and Accountability Act ("HIPAA"), group health plans generally may not establish rules for eligibility based on any of the following factors relating to an individual or a dependent of the individual: (1) health status, (2) medical condition, (3) claims experience, (4) receipt of health care, (5) medical history, (6) genetic information, (7) evidence of insurability, or (8) disability. In addition, a group health plan may not charge an individual a greater premium based on any of such factors.

An excise tax is imposed on the failure of a group plan to satisfy the nondiscrimination rule. In general, the excise tax is imposed on the employer sponsoring the plan and is equal to $100 per day per individual as long as the plan is not in compliance.

Under prior law, there were no exceptions to these rules for church plans.

Explanation of Provision

The Act provides that certain church plans are not treated as violating HIPAA's health plan eligibility requirements merely because the plan requires evidence of good health in order for an individual to enroll in the plan for (1) both any individual who is an employee of an employer with 10 or fewer employees and any self-employed individual or (2) any individual who enrolls after the first 90 days of eligibility under the plan. The provision applies to a church plan for a year if the plan included either of such provisions

requiring evidence of good health on July 15, 1997, and at all times thereafter before the beginning of the year.

Effective Date

The provision is effective as if included in HIPAA.

Revenue Effect

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

D. Date for Adoption of Plan Amendments (sec. 1541 of the Act)

Present and Prior 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.

Explanation of Provision

The Act provides that any amendments to a plan or annuity contract required to be made by the Act are not required to be made before the first day of the first plan year beginning on or after January 1, 1999. In the case of a governmental plan, the date for amendments is extended to the first plan year beginning on or after January 1, 2001. The Act also provides that if an amendment is made pursuant to the Act (whether or not the amendment is required) before the date for required plan amendments, the plan or contract is operated in a manner consistent with the amendment during a period and the amendment is effective retroactively to such period (1) the plan or contract will not fail to be treated as operated in accordance with its terms for such period merely because it is operated in a manner consistent with the amendment, and (2) the plan will not fail to meet the anti-cutback provisions applicable to qualified retirement plans by reason of such a plan amendment.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

TITLE XVI. TECHNICAL CORRECTIONS PROVISIONS

Except as otherwise provided, the technical corrections contained in the Act generally are effective as if included in the originally enacted related legislation.

TECHNICAL CORRECTIONS TO THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

A. Small Business-Related Provisions

1. Returns relating to purchases of fish (sec. 1601(a)(1) of the Act and sec. 6050R(c)(1) of the Code)

Prior Law

Every person engaged in the trade or business of purchasing fish for resale must file an informational return reporting its purchases from any person that is engaged in the trade or business of catching fish which are in excess of $600 for any calendar year. Persons filing such an informational return relating to the purchase of fish must furnish a statement showing the name and address of the person filing the return, as well as the amount shown on the return, to each person whose name is required to be disclosed on the return.

Explanation of Provision

Every person filing an informational return relating to the purchase of fish must furnish a statement showing the phone number of the person filing the return, as well as such person's name, address and the amount shown on the return, to each person whose name is required to be disclosed on the return.

2. Charitable remainder trusts not eligible to be electing small business trusts (sec. 1601(c)(1) of the Act and sec. 1361(c)(1)(B) of the Code)

Prior Law

An electing small business trust may be a shareholder in an S corporation. In order to qualify for this treatment, all beneficiaries of the electing small business trust generally must be individuals or estates eligible to be S corporation shareholders. An exempt trust may not qualify as an electing small business trust.

Explanation of Provision

The provision clarifies that charitable remainder annuity trusts and charitable remainder unitrusts may not be electing small business trusts.

3. Clarify the effective date for post-termination transition period provision (sec. 1601(c)(2) of the Act)

Prior Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distribu-

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

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

The Small Business Act expanded the post-termination period 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" was 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. The Small Business Act provision was effective for taxable years beginning after December 31, 1996.

Explanation of Provision

The technical correction clarifies that the effective date for the Small Business Act provision affecting the post-termination transition period is for determinations after December 31, 1996, not for determinations with respect to taxable years beginning after December 31, 1996. However, in no event will the post-termination transition period expanded by the Small Business Act end before the end of the 120-day period beginning after the date of enactment of this Act.

4. Treatment of qualified subchapter S subsidiaries (sec. 1601(c)(3) of the Act and sec. 1361(b)(3) of the Code)

Prior Law

Pursuant to a provision of the Small Business Act, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that (1) 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 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, for all purposes of the Code, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

The legislative history of the provision provides that if an election is made to treat an existing 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.

Explanation of Provision

The technical correction provides that the Secretary of the Treasury may provide, by regulations, instances where the separate corporate existence of a qualified subchapter S subsidiary may be taken into account for purposes of the Code. Thus, if an S corporation owns 100 percent of the stock of a bank (as defined in sec. 581) and elects to treat the bank as a qualified subchapter S subsidiary, it is expected that Treasury regulations would treat the bank as a separate legal entity for purposes of those Code provisions that apply specifically to banks (e.g., sec. 582).

Treasury regulations also may provide exceptions to the general rule that the qualified subchapter S subsidiary election is treated as a deemed section 332 liquidation of the subsidiary in appropriate cases. In addition, if the effect of a qualified subchapter S subsidiary election is to invalidate an election to join in the filing of a consolidated return for a group of subsidiaries that formerly joined in such filing, Treasury regulations may provide guidance as to the consolidated return effects of the S election.

B. Pension Provisions

1. Salary reduction simplified employee pensions ("SARSEPS") (sec. 1601(d)(1)(B) of the Act and sec. 408(k)(6) of the Code)

Prior Law

SARSEPs were repealed for years beginning after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer was not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, may continue to receive contributions under the rules in effect prior to January 1, 1997.

Explanation of Provision

The Act amends Code section 408(k)(6) to clarify that new employees of an employer hired after December 31, 1996, may participate in a SARSEP of an employer established before January 1, 1997.

2. SIMPLE retirement plans (secs. 1601(d)(1)(A) and (d)(1)(C)–(F) and 1601(d)(2) of the Act)

a. Reporting requirements for SIMPLE IRAs (sec. 1601(d)(1)(A) of the Act and sec. 408(i) of the Code)

Prior Law

A trustee of an individual retirement account and the issuer of an individual retirement annuity must furnish reports regarding

the account or annuity to the individual for whom the account or annuity is maintained not later than January 31 of the calendar year following the year to which the reports relate. In the case of a SIMPLE IRA, such reports are to be furnished within 30 days after each calendar year.

Explanation of Provision

The Act conforms the time for providing reports for SIMPLE IRAs to that for IRA reports generally. Thus, the Act would provide that the report required to be furnished to the individual under a SIMPLE IRA would be provided within 31 days after each calendar year.

b. Notification requirement for SIMPLE IRAs (sec. 1601(d)(1)(C) of the Act and secs. 408(l)(2) and 6693(c) of the Code)

Prior Law

The trustee of any SIMPLE IRA is required to provide the employer maintaining the arrangement a summary plan description containing basic information about the plan. 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.

Explanation of Provision

The Act provides that issuers of annuities for SIMPLE IRAs have the same reporting requirements as SIMPLE IRA trustees.

c. Maximum dollar limitation for SIMPLE IRAs (sec. 1601(d)(1)(D) of the Act and sec. 408(p) of the Code)

Prior Law

The Small Business Act created a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE plan can be either an individual retirement arrangement ("IRA") for each employee or part of a qualified cash or deferred arrangement ("a 401(k) plan"). A SIMPLE IRA permits employees to make elective contributions up to $6,000 per year to their IRA. 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, unless the employer elects a lower percentage matching contribution (but not less than 1 percent of each employee's compensation). Alternatively, 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. The employer contribution amounts are

contributed to the employee's IRA. The maximum contribution limitation to an IRA is $2,000.

Explanation of Provision

The Act provides that in the case of a SIMPLE IRA, the $2,000 maximum limitation applicable to IRAs is increased to the limitations in effect for contributions made under a qualified salary reduction arrangement. This includes employee elective contributions and required employer contributions.

d. Application of exclusive plan requirement for SIMPLE IRAs to noncollectively bargained employees (sec. 1601(d)(1)(E) of the Act and sec. 408(p)(2)(D) of the Code)

Prior Law

A SIMPLE IRA will be treated as a qualified salary reduction arrangement provided the employer does not maintain a qualified plan during the same time period the SIMPLE IRA is maintained. Collectively bargained employees can be excluded from participation in the SIMPLE IRA and may be covered under a plan established by the employer as a result of a good faith bargaining agreement.

Explanation of Provision

The Act provides that an employer who maintains a plan for collectively bargained employees is permitted to maintain a SIMPLE IRA for noncollectively bargained employees.

e. Application of exclusive plan requirement for SIMPLE IRAs in the case of mergers and acquisitions (sec. 1601(d)(1)(F) of the Act and sec. 408(p)(2) of the Code)

Prior Law

Only employers who employ 100 or fewer employees who received compensation for the preceding year of at least $5,000 are eligible to establish a SIMPLE IRA. An eligible employer maintaining a SIMPLE IRA who fails to be an eligible employer due to an acquisition, disposition or similar transaction is treated as an eligible employer for the 2 years following the last year the employer was eligible provided rules similar to the special coverage rules of section 410(b)(6)(C)(i) apply. There is no parallel provision with respect to an employer who, because of an acquisition, disposition or similar transaction, maintains a qualified plan and a SIMPLE IRA at the same time.

Explanation of Provision

The Act provides that if an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year.

f. Top-heavy exemption for SIMPLE 401(k) arrangements (sec. 1601(d)(2)(A) of the Act and sec. 401(k)(11)(D) of the Code)

Prior Law

A plan meeting the SIMPLE 401(k) requirements for any year is not treated as a top-heavy plan under section 416 for the year. This rule was intended to apply only to SIMPLE 401(k)s, and not other plans maintained by the employer.

Explanation of Provision

The Act provides that the top-heavy exemption applies to a plan which permits only contributions required to satisfy the SIMPLE 401(k) requirements.

g. Cost of living adjustments for SIMPLE 401(k) arrangements (sec. 1601(d)(2)(B) of the Act and sec. 401(k)(11) of the Code)

Prior Law

The $6,000 limit on deferrals to a SIMPLE IRA is subject to a cost-of-living adjustment. There is no parallel provision applicable to a SIMPLE 401(k) arrangement.

Explanation of Provision

The Act provides that the $6,000 limit on elective deferrals under a SIMPLE 401(k) arrangement will be adjusted at the same time and in the same manner as for SIMPLE IRAs.

h. Employer deduction for SIMPLE 401(k) arrangements (sec. 1601(d)(2)(C) of the Act and sec. 404(a)(3) of the Code)

Prior Law

Contributions paid by an employer to a profit sharing or stock bonus plan are deductible by the employer for a taxable year to the extent the contributions do not exceed 15-percent of the compensation otherwise paid or accrued during the taxable year to the participants under the plan. Contributions paid by an employer to a profit sharing or stock bonus plan that are not deductible because they are in excess of the 15-percent limitation are subject to a 10-percent excise tax payable by the employer making the contribution.

Explanation of Provision

The Act provides that to the extent that contributions paid by an employer to a SIMPLE 401(k) arrangement satisfy the contribution requirements of section 401(k)(11)(B), such contributions are deductible by the employer for the taxable year.

i. Notification and election periods for SIMPLE 401(k) arrangements (sec. 1601(d)(2)(D) of the Act and sec. 401(k)(11) of the Code)

Prior Law

An employer maintaining a SIMPLE 401(k) arrangement is required to make a matching contribution for employees making elective deferrals of up to 3-percent of compensation (or, alternatively, elect to make a 2-percent of compensation nonelective contribution on behalf of all eligible employees). An employer electing to make a 2-percent nonelective contribution is required to notify all employees of such election within a reasonable period of time before the 60th day before the beginning of the year.

An employer maintaining a SIMPLE IRA is required to notify each employee of the employee's opportunity to make or modify salary reduction contributions as well as the contribution alternative chosen by the employer within a reasonable period of time before the employee's election period. The employee's election period is the 60-day period before the beginning of any year (and the 60-day period before the first day such employee is eligible to participate).

Explanation of Provision

The Act extends the employer notice and employee election requirements of SIMPLE IRAs to SIMPLE 401(k) arrangements.

Effective Date

The provision is effective with respect to calendar years beginning after the date of enactment.

j. Treatment of Indian tribal governments under section 403(b) (sec. 1601(d)(4) of the Act and sec. 403(b) of the Code)

Prior Law

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. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8).

Explanation of Provision

The Act clarifies that an employee participating in a 403(b) annuity contract of the Indian tribal government would be permitted to roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

k. Special rules for chaplains and self-employed ministers (sec. 1601(d)(6) of the Act and sec. 414(e)(5)(A) of the Code)

Prior Law

Ministers employed by an employer other than a church may participate in their denominational plan.

Certain service of a self-employed minister is treated as years of service for purposes of calculating the exclusion allowance applicable to section 403(b) annuities.

Explanation of Provision

The provision clarifies that a minister may participate in the denominational plan, whether or not the minister is employed by a tax-exempt employer or a taxable employer.

The provision clarifies that the exclusion amount is determined by taking into account the minister's self-employed earnings with respect to years of service taken into account in calculating the exclusion amount.

C. Foreign Provisions

1. Measurement of earnings of controlled foreign corporations (sec. 1601(e) of the Act and section 956 of the Code)

Prior Law

U.S. 10-percent shareholders of a controlled foreign corporation (CFC) are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in United States property. For this purpose, earnings include both current earnings and profits (not including a deficit) referred to in section 316(a)(2) and accumulated earnings and profits referred to in section 316(a)(1). It could be argued that this definition of earnings takes current year earnings into account twice.

Explanation of Provision

The technical correction clarifies that accumulated earnings and profits of a CFC taken into account under section 956(b)(1)(A) for purposes of determining the CFC's earnings invested in United States property do not include current earnings (which are taken into account separately under sec. 956(b)(1)(B)). A similar technical correction to the definition of earnings for purposes of prior-law section 956A (relating to a CFC's earnings invested in excess passive assets) was enacted with the Small Business Job Protection Act of 1996 (section 1703(i)(2)).

2. Transfers to foreign trusts at fair market value (sec. 1601(i)(2) of the Act and sec. 679 of the Code)

Prior Law

A U.S. person who transfers property to a foreign trust which has U.S. beneficiaries generally is treated as the owner of such trust. However, this rule does not apply where the U.S. person

transfers property to a trust in exchange for fair market value consideration. In determining whether the U.S. person receives fair market value consideration, obligations of certain related persons are not taken into account. For this purpose, related persons include the trust, any grantor or beneficiary of the trust, and certain persons who are related to any such grantor or beneficiary.

Explanation of Provision

The technical correction clarifies that, for purposes of determining whether a U.S. person's transfer to a trust is for fair market value consideration, the related persons whose obligations are disregarded include any owner of the trust and certain persons who are related to any such owner.

3. Treatment of trust as U.S. person (sec. 1601(i)(3) of the Act and secs. 641 and 7701(a)(30) of the Code)

Prior Law

A trust is considered to be a U.S. person if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust.

These criteria regarding the treatment of a trust as a U.S. person are effective for taxable years beginning after December 31, 1996. The Internal Revenue Service 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. To qualify for such treatment, the trustee (1) must initiate modification of the trust to conform to the new criteria by the due date for filing the trust's return for its first taxable year beginning after 1996, (2) must complete the modification within two years of such date, and (3) must attach the required statement to the trust returns for the taxable years beginning after 1996.[314]

Explanation of Provision

The technical correction clarifies that a trust is treated as a U.S. person as long as one or more U.S. *persons* have the authority to control all substantial decisions of the trust (and a U.S. court can exercise primary supervision). Accordingly, the fact that a substantial decision of the trust is controlled by a U.S. person who is not a fiduciary would not cause the trust not to be treated as a U.S. person. In addition, the technical correction clarifies that a trust that is a foreign trust under these criteria is not considered to be present or resident in the United States at any time. Finally, the technical correction provides the Secretary of Treasury with authority to allow reasonable time for U.S. trusts in existence on August 20, 1996 to make modifications in order to comply with the new criteria for treatment of a trust as a U.S. person.

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[314] Notice 96–65, 1996–2 C.B. 232. See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS–12–96), December 12, 1996, pp. 277–278.

D. Other Provisions

1. Phaseout and expiration of excise tax on luxury automobiles (sec. 1601(f)(3) of the Act and secs. 4001 and 4003 of the Code)

Prior Law

An excise tax is imposed on the sale of automobiles whose price exceeds a designated threshold ($36,000 for 1997). The excise tax is imposed at a rate of 8-percent on the excess of the sales price above the designated threshold. The 8-percent rate declines by one percentage point per year until reaching 3 percent in 2002. The $36,000 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. However, under section 4003 of the Code, a 10-percent tax was 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.

The tax under section 4001 applies to sales before January 1, 2003. The tax under section 4003 has no termination date.

Explanation of Provision

The Act clarifies that the phased reduction in luxury excise tax rates and the expiration date of December 31, 2002, enacted as part of the Small Business Act, apply both for the tax imposed on the purchase of new automobiles under section 4001 and for the tax imposed for the separate purchase of vehicles and parts and accessories therefor under section 4003.

Effective Date

The provision is effective for sales after the date of enactment of the 1997 Act.

2. Treatment of certain reserves of thrift institutions (sec. 1601(f)(5) of the Act and secs. 593(e) and 1374 of the Code)

Prior Law

A provision of the Small Business Act repealed the percentage-of-taxable income method for deducting bad debts applicable to thrift institutions. The portion of the section 481(a) adjustment applicable to pre-1988 reserves of an institution required to change its method of accounting generally is not restored to income unless the institution makes a distribution to which section 593(e) applies. Section 593(e) provides that if a institution makes a nonliquidating distribution in an amount in excess of its post-1951 accumulated earnings and profits, such excess will be treated as a distribution of the post-1987 reserve for bad debts, requiring recapture of such amount.

Another provision of the Small Business Act allows a bank or a thrift institution to elect to be treated as an S corporation so long as the entity does not use a reserve method of accounting for bad debts. The earnings of an S corporation increase the corporation's accumulated adjustments account, but do not increase its accumulated earnings and profits (sec. 1368). In addition, any net unrealized built-in gains of a C corporation that converts to S corporation status that are recognized during the 10-year period beginning with the date of such conversion generally are subject to corporate-level tax (sec. 1374). Section 481(a) adjustments taken into account during the 10-year period generally are subject to section 1374.

Explanation of Provision

The Act provides rules to clarify the section 593(e) treatment of pre-1988 bad debt reserves of thrift and former thrift institutions that become S corporations. The technical corrections provide that (1) the accumulated adjustments account of an S corporation would be treated the same as post-1951 earnings and profits for purposes of section 593(e) and (2) section 593(e) would apply irrespective of section 1374 (e.g., distributions that trigger section 593(e) would be subject to corporate-level recapture even if such distributions occur after the 10-year period of section 1374).

3. "FASIT" technical corrections (sec. 1601(f)(6) of the Act and sec. 860L of the Code)

Prior Law

In general

A "financial asset securitization investment trust" ("FASIT") is designed to facilitate 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. In addition, a FASIT generally must 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 (called "regular interests") that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. In general, those requirements must be met "after the startup date." Instruments bearing yields to maturity over 5 percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") may be held only by domestic C corporations that are not exempt from income tax.

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);[315] (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.

Definition of "FASIT"

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; (6) a regular interest in another FASIT; and (7) a regular interest in a REMIC. 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.

Explanation of Provision

Definition of regular interest

The Act provides that the requirement of a "regular interest" must be met "on or after the startup date," instead of just "after the startup date."

Correction of cross reference

The Act corrects an incorrect cross reference in section 860L(d) from section 860I(c)(2) to section 860I(b)(2).

Tax on prohibited transactions

The Act provides that the tax on prohibited transactions would not apply to dispositions of foreclosure property or hedges using the similar exception applicable to REMICs.

4. Qualified State tuition programs (sec. 1601(h)(1) of the Act and sec. 529 of the Code)

Prior Law

Section 529 provides tax-exempt status to certain qualified State tuition programs and provides rules governing the tax treatment of distributions from such programs. Section 529 was effective on the date of enactment of the Small Business Job Protection Act of

[315] 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 real estate mortgage investment conduit ("REMIC") in section 860F(a)(4).

1996, but a special transition rule provides 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, without regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings.

Explanation of Provision

The provision clarifies that, if a State program under which persons may purchase tuition credits comes into compliance with the requirements of a "qualified State tuition program" as defined in section 529 within a specified time period, then such program will be treated as a qualified State tuition program with respect to any contributions (and earnings allocable thereto) made pursuant to a contract entered into under the program before the date on which the program comes into compliance with the present-law requirements of a qualified State tuition program under section 529.

5. Adoption credit (sec. 1601(h)(2) of the Act, sec. 1807 of the Small Business Act, and sec. 23 of the Code)

Prior Law

Taxpayers are allowed a maximum nonrefundable tax credit against income tax liability of $5,000 per child for qualified adoption expenses ($6,000 in the case of certain domestic adoptions) paid or incurred by the taxpayer. 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.

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.

Explanation of Provision

The technical correction conforms the treatment of otherwise qualified adoption expenses paid or incurred in years after the year the adoption becomes final to the treatment of expenses paid or incurred in the year the adoption becomes final. Another technical correction repeals as "deadwood" an ordering rule inadvertently included in the credit.

6. Phaseout of adoption assistance exclusion (sec. 1601(h)(2) of the Act, sec. 1807 of the Small Business Act, and sec. 137 of the Code)

Prior Law

The adoption tax credit and the exclusion for employer provided adoption assistance are generally phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and are 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).

Explanation of Provision

The technical correction conforms the phaseout range of the adoption assistance exclusion to the phaseout range of the credit for qualified adoption expenses.

A. Medical Savings Accounts (sec. 1602(a) of the Act and sec. 220 of the Code)

1. Additional tax on distributions not used for medical purposes

Prior Law

Distributions from a medical savings account ("MSA") that are not used for medical expenses are includible in gross income and subject to a 15-percent additional tax unless the distribution is after age 65 or death or on account of disability. A similar additional 10-percent tax is imposed on early withdrawals from individual retirement arrangements and qualified pension plans. The 10-percent additional tax on early withdrawals is not treated as tax liability for purposes of the minimum tax. No such rule applies to the 15-percent additional tax applicable to MSAs.

Explanation of Provision

The Act provides that the 15-percent tax on nonmedical withdrawals from an MSA is not treated as tax liability for purposes of the minimum tax.

2. Definition of permitted coverage

Prior Law

In order to be eligible to have an MSA an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage. Medicare supplemental plans are one of the types of permitted coverage, even though an individual covered by Medicare is not eligible to have an MSA.

Explanation of Provision

Under the Act, Medicare supplemental plans would be deleted from the types of permitted coverage an individual may have and still qualify for an MSA.

3. Taxation of distributions

Prior Law

In order to be eligible to have a medical savings account ("MSA") an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage and must be either (1) a self-employed individual, or (2) employed by a small employer. Distributions from an MSA for the medical expenses of the MSA account holder and his or her spouse or dependents are generally excludable from income. However, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was an eligible individual for the month in which the expenses were incurred. This

rule is designed to ensure that MSAs are 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.

Explanation of Provision

The Act would clarify that, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible health plan (and no other health plan except for plans that provide certain permitted coverage) in the month in which the expenses were incurred. That is, the individual for whom the expenses were incurred does not have to be self employed or employed by a small employer in order for a withdrawal for medical expenses to be excludible.

4. Penalty for failure to provide required reports

Prior Law

Trustees of an MSA are required to provide such reports to the Secretary and the account holder as the Secretary may require. A penalty of $50 applies with respect to each failure to provide a required report. Separate penalties apply to information returns required by the Code.

Explanation of Provision

The Act provides that the $50 penalty does not apply to information returns.

B. Definition of Chronically Ill Individual Under a Qualified Long-Term Care Insurance Contract (sec. 1602(b) of the Act and sec. 7702B(c)(2) of the Code)

Prior Law

Under the long-term care insurance rules, 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 level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. A contract is not treated as a qualified long-term care insurance contract unless the determination of whether an individual is a chronically ill individual takes into account at least 5 of such activities.

Explanation of Provision

The technical correction clarifies that the five-activity requirement—i.e., that the number of activities of daily living that are

taken into account not be less than five—applies only for purposes of the first of three alternative definitions of a chronically ill individual (Code sec. 7702B(c)(2)(A)(i)), that is, by reason of the individual 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. Thus, the 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.

C. Deduction for Long-Term Care Insurance of Self-Employed Individuals (sec. 1602(c) of the Act and sec. 162(l)(2) of the Code)

Prior Law

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. In the case of a qualified long-term care insurance contract, only eligible long-term care premiums (as defined for purposes of the medical expense deduction) are taken into account in determining the deduction for health insurance expenses of a self-employed individual.

Explanation of Provision

The technical correction applies the rules for the deduction for health insurance expenses of a self-employed individual separately with respect to (1) plans that include coverage for qualified long-term care services or that are qualified long-term care insurance contracts, and (2) plans that do not include such coverage and are not such contracts. Thus, the provision clarifies that the fact that an individual is eligible for employer-subsidized health insurance does not 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.

D. Applicability of Reporting Requirements of Long-Term Care Contracts and Accelerated Death Benefits (sec. 1602(d) of the Act and sec. 6050Q of the Code)

Prior Law

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 dollar cap on per diem contracts only. If the aggregate amount of periodic payments under all qualified long-term care contracts exceeds the dollar cap for the period, then the amount of such excess payments is excludable only to the extent of the individual's costs (that are not otherwise compensated for by insurance or otherwise) for long-term care services during the period.

An exclusion from gross income is provided for 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 (the accelerated death benefit rules).

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), and a payor of amounts treated as subject to reporting under the accelerated death benefit rules, 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. A payor is also required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition the 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.

Explanation of Provision

The technical correction clarifies that the reporting requirements include the need to report the address and phone number of the information contact. This conforms these reporting requirements to the requirements of the Taxpayer Bill of Rights 2.

E. Consumer Protection Provisions for Long-Term Care Insurance Contracts (sec. 1602(e) of the Act and sec. 7702B(g)(4)(b) of the Code)

Prior Law

The long-term care insurance rules include consumer protection provisions (sec. 7702B(g)). Among these provisions is a requirement that the issuer of a contract offer to the policyholder a nonforfeiture provision that meets certain requirements. The requirements include a rule that 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 Secretary for the same contract form.

Explanation of Provision

The technical correction clarifies that 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 (not by the Secretary) for the same contract form.

F. Insurable Interests Under the COLI Provision (sec. 1602(f)(1) of the Act and sec. 264(a)(4) of the Code)

Prior Law

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 (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer (the COLI rule). An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Explanation of Provision

The technical correction is intended to prevent unintended avoidance of the COLI rule by clarifying that the rule relates to life insurance policies or annuity or endowment contracts covering any individual who (1) is or was an officer or employee of, or (2) is or was financially interested in, any trade or business carried on currently or formerly by the taxpayer. Thus, for example, the provision would clarify the treatment of interest on debt with respect to contracts covering former employees of the taxpayer. As another example, the provision would clarify the treatment of interest on debt with respect to a business formerly conducted by the taxpayer and transferred to an affiliate of the taxpayer. No inference is intended as the interpretation of this provision under prior law.

G. Applicable Period for Purposes of Applying the Interest Rate for a Variable Rate Contract Under the COLI Rules (sec. 1602(f)(2) of the Act and sec. 264(d)(2)(B)(ii) of the Code)

Prior Law

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 (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. 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 taxpayer does not exceed Moody's Corporate Bond Yield Average—Monthly Aver-

age Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less.

Explanation of Provision

The technical correction provides that an election of an applicable period for purposes of applying the interest rate for a variable rate contract can be made no later than the 90th date after the date of enactment of the proposal, and applies to the taxpayer's first taxable year ending on or after October 13, 1995. If no election is made, the applicable period is the policy year. The policy year is the 12-month period beginning on the anniversary date of the policy.

H. Definition of 20-Percent Owner for Purposes of Key Person Exception Under COLI Rule (sec. 1602(f)(3) of the Act and sec. 264(d)(4) of the Code)

Prior Law

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 (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

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. Employees are to 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, the statute states that a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the employer.

Explanation of Provision

The technical correction clarifies that, in determining a key person, 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.

I. Effective Date of Interest Rate Cap on Key Persons and Pre-1986 Contracts Under the COLI Rule (sec. 1602(f)(4) of the Act and sec. 501(c) of HIPA)

Prior Law

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 (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. 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 taxpayer 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.

The interest rate cap on key persons and pre-1986 contracts is effective with respect to interest paid or accrued for any month beginning after December 31, 1995. Another part of the provision provides that the interest rate cap on key employees and pre-1986 contracts applies to interest paid or accrued after October 13, 1995.

Explanation of Provision

The technical correction clarifies that, under the COLI rule, the interest rate cap on key persons and pre-1986 contracts applies to interest paid or accrued for any month beginning after December 31, 1995. This technical correction eliminates the discrepancy between the October and the December dates in the grandfather rule for pre-1986 contracts.

J. Clarification of Contract Lapses Under Effective Date Provisions of the COLI Rule (sec. 1602(f)(5) of the Act and sec. 501(d)(2) of HIPA)

Prior Law

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 (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Additional limitations are imposed on the deductibility of interest with respect to single premium contracts, and interest 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. 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).

This COLI rule is phased in. In connection with the phase-in rule, a transition rule provides that any amount included in income

during 1996, 1997, or 1998, that is received under a contract described in the provision 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. The lapse 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). This lapse 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.

Explanation of Provision

The technical correction clarifies that, under the transition relief provided under the COLI rule, the 4-out-of-7 rule and the single premium rule are not to apply solely by reason of a lapse occurring after October 13, 1995, by reason of no additional premiums being received under the contract.

K. Requirement of Gain Recognition on Certain Exchanges (sec. 1602(g) (1) and (2) of the Act, sec. 511 of the Act, and sec. 877(d)(2) of the Code)

Prior Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status. Gain recognition is required on certain exchanges of property following loss of U.S. citizenship or U.S. residency status, unless a gain recognition agreement is entered into. In addition, regulatory authority is granted to apply this rule to the 15-year period beginning 5 years before the loss of U.S. citizenship or U.S. residency status.

Explanation of Provision

The technical correction clarifies that the period to which the general rule requiring gain recognition on certain exchanges applies is the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status. In addition, the technical correction clarifies that in the case of an exchange occurring during the 5-year period before the loss of U.S. citizenship or U.S. residency status, any gain required to be recognized under regulations is to be recognized immediately after the date of such loss of U.S. citizenship or U.S. residency status.

L. Suspension of 10-Year Period in Case of Substantial Diminution of Risk of Loss (sec. 1602(g)(3) of the Act, sec. 511 of the Act, and sec. 877(d)(3) of the Code)

Prior Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status. The running of this period with respect to gain on the sale or exchange of any property is suspended for any period during which the individual's risk of loss with respect to the property is substantially diminished.

Explanation of Provision

The technical correction clarifies that the period to which the rule suspending such period in the case of a substantial diminution of risk of loss applies is the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status.

M. Treatment of Property Contributed to Certain Foreign Corporations (sec. 1602(g)(4) of the Act, sec. 511 of the Act, and sec. 877(d)(4) of the Code)

Prior Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status. Special rules apply in the case of certain contributions of U.S. property by such an individual to a foreign corporation during such period.

Explanation of Provision

The technical correction clarifies that the period to which the rule regarding certain contributions to foreign corporations applies is the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status. The technical correction also clarifies that the rule applies in the case of property the income from which, immediately before the contribution, was from U.S. sources.

N. Credit for Foreign Estate Tax (sec. 1602(g)(6) of the Act, sec. 511 of the Act, and sec. 2107(c) of the Code)

Prior Law

Under the expatriation tax provisions in section 2107, special estate tax treatment applies to certain former U.S. citizens and former long-term U.S. residents who die within 10 years following the date of loss of U.S. citizenship or U.S. residency status. Special rules provide a credit against the U.S. estate tax for foreign estate taxes paid with respect to property that is includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions.

Explanation of Provision

The technical correction clarifies the formula for determining the amount of the foreign tax credit allowable against U.S. estate taxes on property includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions. The credit for the estate taxes paid to any foreign country generally is limited to the lesser of (1) the foreign estate taxes attributable to the property includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions or (2) the U.S. estate tax attributable to property that is subject to estate tax in such foreign country and is includible in the decedent's U.S. estate solely by reason of the expatriation tax provisions. The amount of taxes attributable to such property is determined on a pro rata basis.

A. Reasonable Cause Abatement for First-Tier Intermediate Sanctions Excise Tax (sec. 1603(a) of the Act and sec. 4962 of the Code)

Present and Prior Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax 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.

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. Organization managers who participate in an excess benefit transaction knowing that it is improper are subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit. Additional second-tier taxes equal to 200 percent of the amount of the excess benefit may be imposed on a disqualified person if there is no correction of the transaction within a specified time period.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under sections 4941 (on acts of self-dealing between private foundations and disqualified persons), 4942 (for failure by private foundations to distribute a minimum amount of income), and 4943 (on private foundations with excess business holdings).

In enacting the new excise taxes on excess benefit transactions, Congress explicitly intended to provide the IRS with abatement authority under section 4962.[316] However, the abatement rules of section 4962 applied only to qualified first-tier taxes imposed by subchapter A or C of Chapter 42. The section 4958 excise tax is located in subchapter D of Chapter 42. The failure to cross reference subchapter D in section 4962 meant that IRS did not have such abatement authority with respect to the section 4958 excise taxes.

Explanation of Provision

The Act amends section 4962(b) to include a cross-reference to first-tier taxes imposed by subchapter D (i.e., the section 4958 excise taxes on excess benefit transactions). Thus, the IRS has authority to abate the first-tier excise taxes on excess benefit transactions in cases where 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.

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[316] See report of the House Committee on Ways and Means (H. Rept. 104–506) accompanying H.R. 2377, p. 59.

B. Reporting by Public Charities With Respect to Intermediate Sanctions and Certain Other Excise Tax Penalties (sec. 1603(b) of the Act and sec. 6033 of the Code)

Present and Prior Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax 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. No tax is imposed on the organization itself with respect under section 4958.

Section 4911 imposes an excise tax penalty on excess lobbying expenditures made by public charities. The tax is imposed on the organization itself. Section 4912 imposes a penalty excise tax on certain public charities that make disqualifying lobbying expenditures and section 4955 imposes a penalty excise tax on political expenditures of section 501(c)(3) organizations. Both of these penalty taxes are imposed not only on the affected organization, but also on organization managers who agree to an expenditure knowing that it is improper.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under section 4955.[317]

Under section 6033(b)(10), 501(c)(3) organizations are required to report annually on Form 990 any amounts paid by the organization under section 4911, 4912, and 4955. Thus, although sections 4912 and 4955 impose excise taxes on organization managers, organizations technically were not required to report any such excise taxes paid by such managers.

In addition, under section 6033(b)(11), an organization exempt from tax under section 501(c)(3) must report on Form 990 any amount of excise tax on excess benefit transactions paid by the organization, or any disqualified person with respect to such organization, during the taxable year. The Code did not explicitly require the reporting of any excess benefit excise taxes paid by an organization manager solely in his or her capacity as such (i.e., an organization manager might also be a disqualified person with respect to an excess benefit transaction, in which case any tax paid would be reported).

Explanation of Provision

The Act makes the reporting requirements of section 6033(b)(10) and (11) consistent with the excise tax penalty provisions to which they relate. Thus, section 6033(b)(10) is amended to require 501(c)(3) organizations to report any amounts of tax imposed under sections 4911, 4912, and 4955 on the organization or any organiza-

[317] A separate provision in the Act makes a technical correction to section 4962(b) to permit the abatement of first-tier penalty excise taxes imposed under section 4958.

tion manager of the organization. In addition, the Act requires reporting with respect to any reimbursements paid by an organization with respect to taxes imposed under sections 4912 or 4955 on any organization manager of the organization. Section 6033(b)(11) is amended to require 501(c)(3) organizations to report any amounts of tax imposed under section 4958 on any organization manager or any disqualified person, as well as any reimbursements of section 4958 excise tax liability paid by the organization to such organization managers or disqualified persons.

In addition, the Act clarifies that no reporting is required under sections 6033(b)(10) or (11) in the event a first-tier penalty excise tax imposed under section 4955 or section 4958 is abated by the IRS pursuant to its authority under section 4962.

A. Correction of GATT Interest and Mortality Rate Provisions in the Retirement Protection Act (sec. 1604(b)(3) of the Act and sec. 1449(a) of the Small Business Act)

Prior Law

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreements on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations under section 415. 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 by the plan. Under GATT, 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 was generally effective as of the first day of the limitation year beginning in 1995.

The Small Business Act conformed the effective date of these changes to the effective date of similar changes by providing generally that, in the case of a plan that was adopted and in effect before December, 8, 1994, the GATT change is not effective with respect to benefits accrued before the earlier of (1) the later of the date a plan amendment applying the amendments is adopted or made effective or (2) the first day of the first limitation year beginning after December 31, 1999. The Small Business Act provides that "Determinations under section 415(b)(2)(E) before such earlier date are to be made with respect to such benefits on the basis of such section as in effect on December 7, 1994 (except that the modification made by section 1449(b) of the Small Business Job Protection Act of 1996 shall be taken into account), and the provisions of the plan as in effect on December 7, 1994, but only if such provisions of the plan meet the requirements of such section (as so in effect)."

Explanation of Provision

The provision in the Small Business Act was intended to permit plans to apply pre-GATT law under section 415(b)(2)(E) for a transition period. The Act conforms the statute to this intent by providing that determinations under section 415(b)(2)(E) before such earlier date are to be made with respect to such benefits on the basis of such section as in effect on December 7, 1994 and the provisions of the plan as in effect on December 7, 1994, but only if such provisions of the plan meet the requirements of such section (as so in effect).

B. Clarify Definition of Indian Reservation Under Section 168(j)(6) (sec. 1604(c) of the Act and sec 168(j)(6) of the Code)

Prior Law

Section 168(j)(6) provides for accelerated depreciation for certain property located on Indian reservations. For this purpose, the term "Indian reservation" means a reservation as defined in either (a) section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d)), or (b) section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)). In addition, section 45A (which provides for an incremental Indian employment credit) incorporates by reference the same definition of "Indian reservation" contained in section 168(j)(6). Section 3(d) of the Indian Financing Act of 1974 includes not only officially designated Indian reservations and public domain Indian allotments, but also all "former Indian reservations in Oklahoma," which covers most of the State of Oklahoma even though parts of such "former Indian reservations" may no longer have a significant nexus to an Indian tribe.

Explanation of Provision

For purposes of the section 168(j)(6) definition of "Indian reservation," the term "former reservations in Oklahoma" is defined as lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151.

Effective Date

The provision generally is effective as if included in the Omnibus Budget Reconciliation Act of 1993 (i.e., the technical correction applies to property placed in service and wages paid on or after January 1, 1994). However, the provision does not apply to wages claimed on any original return filed prior to March 18, 1997, nor does it apply to property placed in service with a 10-year life or less (without regard to section 168(j)) if accelerated depreciation under section 168(j) was claimed with respect to such property on an original return filed prior to March 18, 1997.

C. Treatment of "Cost-Plus" Contracts Under Section 833 (sec. 1604(d) of the Act and sec. 833 of the Code)

Prior Law

Section 833 provides a special deduction for eligible health insurance organizations equal to (1) 25 percent of the sum of: the claims incurred during the taxable year; and expenses incurred during the year in connection with the administration, adjustment, or settlement of claims, less (2) the adjusted surplus as of the beginning of the year.

Explanation of Provision

The provision clarifies that, for purposes of the section 833 deduction, liabilities incurred during the taxable year under cost-plus

contracts are added to claims incurred under section 833(b)(1)(A)(i). Similarly, for purposes of the section 833 deduction, expenses incurred during the taxable year in connection with the administration of cost-plus contracts are added to expenses incurred under section 833(b)(1)(A)(ii).

D. Related Parties Determined by Reference to Section 267 (sec. 1604(d) of the Act and sec. 267(f) of the Code)

Prior Law

Section 267 disallows loses arising in transactions between certain defined related parties. In the case of related corporations, such losses may be deferred. Several Code provisions, in defining related parties, often incorporate the relationships described in section 267 by cross-reference to such section.

Explanation of Provision

Any provision of the Internal Revenue Code of 1986 that refers to a relationship that would result in loss disallowance under section 267 also refers to relationships where loss is deferred, where such relationship is applicable to the provision.

TITLE XVII. LIMITED TAX BENEFITS SUBJECT TO THE LINE ITEM VETO ACT (sec. 1701 of the Act)

Present and Prior Law

The Line Item Veto Act amended the Congressional Budget and Impoundment Act of 1974 to grant the President the limited authority to cancel specific dollar amounts of discretionary budget authority, certain new direct spending, and limited tax benefits. The Line Item Veto Act provides that the Joint Committee on Taxation is required to examine any revenue or reconciliation bill or joint resolution that amends the Internal Revenue Code of 1986 prior to its filing by a conference committee in order to determine whether or not the bill or joint resolution contains any limited tax benefits and to provide a statement to the conference committee that either (1) identifies each limited tax benefit contained in the bill or resolution, or (2) states that the bill or resolution contains no limited tax benefits. The conferees determine whether or not to include the Joint Committee's statement in the conference report. If the conference report includes the information from the Joint Committee on Taxation identifying provisions that are limited tax benefits, then the President may cancel one or more of those, but only those, provisions that have been identified. If such a conference report contains a statement from the Joint Committee on Taxation that none of the provisions in the conference report are limited tax benefits, then the President has no authority to cancel any of the specific tax provisions, because there are no tax provisions that are eligible for cancellation under the Line Item Veto Act.

Explanation of Provision

The Act contains a list of provisions that were identified by the Joint Committee on Taxation as limited tax benefits within the meaning of the Line Item Veto Act. These provisions are listed below.

(1) Sec. 101(c) (relating to high risk pools permitted to cover dependents of high risk individuals)

(2) Sec. 222 (relating to limitation on qualified 501(c)(3) bonds other than hospital bonds)

(3) Sec. 224 (relating to contributions of computer technology and equipment for elementary or secondary school purposes)

(4) Sec. 312(a) (relating to treatment of remainder interests for purposes of provision relating to gain from sale of principal residence)

(5) Sec. 501(b) (relating to indexing of alternative valuation of certain farm, etc., real property)

(6) Sec. 504 (relating to extension of treatment of certain rents under section 2032A to lineal descendants)

(7) Sec. 505 (relating to clarification of judicial review of eligibility for extension of time for payment of estate tax)

(8) Sec. 508 (relating to treatment of land subject to qualified conservation easement)

(9) Sec. 511 (relating to expansion of exception from generation-skipping transfer tax for transfers to individuals with deceased parents)

(10) Sec. 601 (relating to the research tax credit)

(11) Sec. 602 (relating to contributions of stock to private foundations)

(12) Sec. 603 (relating to the work opportunity tax credit)

(13) Sec. 604 (relating to orphan drug tax credit)

(14) Sec. 701 (relating to incentives for revitalization of the District of Columbia) to the extent it amends the Internal Revenue Code of 1986 to create sections 1400 and 1400A (relating to tax-exempt economic development bonds)

(15) Sec. 701 (relating to incentives for revitalization of the District of Columbia) to the extent it amends the Internal Revenue Code of 1986 to create section 1400C (relating to first-time homebuyer credit for District of Columbia)

(16) Sec. 801 (relating to incentives for employing long-term family assistance recipients)

(17) Sec. 904(b) (relating to uniform rate of tax on vaccines) as it relates to any vaccine containing pertussis bacteria, extracted or partial cell bacteria, or specific pertussis antigens

(18) Sec. 904(b) (relating to uniform rate of tax on vaccines) as it relates to any vaccine against measles

(19) Sec. 904(b) (relating to uniform rate of tax on vaccines) as it relates to any vaccine against mumps

(20) Sec. 904(b) (relating to uniform rate of tax on vaccines) as it relates to any vaccine against rubella

(21) Sec. 905 (relating to operators of multiple retail gasoline outlets treated as wholesale distributors for refund purposes)

(22) Sec. 906 (relating to exemption of electric and other clean-fuel motor vehicles from luxury automobile classification)

(23) Sec. 907(a) (relating to rate of tax on liquified natural gas determined on basis of BTU equivalency with gasoline)

(24) Sec. 907(b) (relating to rate of tax on methanol from natural gas determined on basis of BTU equivalency with gasoline)

(25) Sec. 908 (relating to modification of tax treatment of hard cider)

(26) Sec. 914 (relating to mortgage financing for residences located in disaster areas)

(27) Sec. 962 (relating to assignment of workmen's compensation liability eligible for exclusion relating to personal injury liability assignments)

(28) Sec. 963 (relating to tax-exempt status for certain State worker's compensation act companies)

(29) Sec. 967 (relating to additional advance refunding of certain Virgin Island bonds)

(30) Sec. 968 (relating to nonrecognition of gain on sale of stock to certain farmers' cooperatives)

(31) Sec. 971 (relating to exemption of the incremental cost of a clean fuel vehicle from the limits on depreciation for vehicles)

(32) Sec. 974 (relating to clarification of treatment of certain receivables purchased by cooperative hospital service organizations)

(33) Sec. 975 (relating to deduction in computing adjusted gross income for expenses in connection with service performed by certain officials) with respect to taxable years beginning before 1991

(34) Sec. 977 (relating to elective carryback of existing carryovers of National Railroad Passenger Corporation)

(35) Sec. 1005(b)(2)(B) (relating to transition rule for instruments described in a ruling request submitted to the Internal Revenue Service on or before June 8, 1997)

(36) Sec. 1005(b)(2)(C) (relating to transition rule for instruments described on or before June 8, 1997, in a public announcement or in a filing with the Securities and Exchange Commission) as it relates to a public announcement

(37) Sec. 1005(b)(2)(C) (relating to transition rule for instruments described on or before June 8, 1997, in a public announcement or in a filing with the Securities and Exchange Commission) as it relates to a filing with the Securities and Exchange Commission

(38) Sec. 1011(d)(2)(B) (relating to transition rule for distributions made pursuant to the terms of a tender offer outstanding on May 3, 1995)

(39) Sec. 1011(d)(3) (relating to transition rule for distributions made pursuant to the terms of a tender offer outstanding on September 13, 1995)

(40) Sec. 1012(d)(3)(B) (relating to transition rule for distributions pursuant to an acquisition described in section 355(e)(2)(A)(ii) of the Internal Revenue Code of 1986 described in a ruling request submitted to the Internal Revenue Service on or before April 16, 1997)

(41) Sec. 1012(d)(3)(C) (relating to transition rule for distributions pursuant to an acquisition described in section 355(e)(2)(A)(ii) of the Internal Revenue Code of 1986 described in a public announcement or filing with the Securities and Exchange Commission) as it relates to a public announcement

(42) Sec. 1012(d)(3)(C) (relating to transition rule for distributions pursuant to an acquisition described in section 355(e)(2)(A)(ii) of the Internal Revenue Code of 1986 described in a public announcement or filing with the Securities and Exchange Commission) as it relates to a filing with the Securities and Exchange Commission

(43) Sec. 1013(d)(2)(B) (relating to transition rule for distributions or acquisitions after June 8, 1997, described in a ruling request submitted to the Internal Revenue Service submitted on or before June 8, 1997)

(44) Sec. 1013(d)(2)(C) (relating to transition rule for distributions or acquisitions after June 8, 1997, described in a public announcement or filing with the Securities and Exchange Commission on or before June 8, 1997) as it relates to a public announcement

(45) Sec. 1013(d)(2)(C) (relating to transition rule for distributions or acquisitions after June 8, 1997, described in a public announcement or filing with the Securities and Exchange Commission on or before June 8, 1997) as it relates to a filing with the Securities and Exchange Commission

(46) Sec. 1014(f)(2)(B) (relating to transition rule for any transaction after June 8, 1997, if such transaction is described in a rul-

ing request submitted to the Internal Revenue Service on or before June 8, 1997)

(47) Sec. 1014(f)(2)(C) (relating to transition rule for any transaction after June 8, 1997, if such transaction is described in a public announcement or filing with the Securities and Exchange Commission on or before June 8, 1997) as it relates to a public announcement

(48) Sec. 1014(f)(2)(C) (relating to transition rule for any transaction after June 8, 1997, if such transaction is described in a public announcement or filing with the Securities and Exchange Commission on or before June 8, 1997) as it relates to a filing with the Securities and Exchange Commission

(49) Sec. 1042(b) (relating to special rules for provision terminating certain exceptions from rules relating to exempt organizations which provide commercial-type insurance)

(50) Sec. 1081(a) (relating to termination of suspense accounts for family corporations required to use accrual accounting) as it relates to the repeal of Internal Revenue Code section 447(i)(3)

(51) Sec. 1089(b)(3) (relating to reformations)

(52) Sec. 1089(b)(5)(B)(i) (relating to persons under a mental disability)

(53) Sec.1171 (relating to treatment of computer software as FSC export property)

(54) Sec. 1175 (relating to exemption for active financing income)

(55) Sec. 1204 (relating to travel expenses of Federal employees doing criminal investigations)

(56) Sec. 1236 (relating to extension of time for filing a request for administrative adjustment)

(57) Sec. 1243 (relating to special rules for administrative adjustment request with respect to bad debts or worthless securities)

(58) Sec. 1251 (relating to clarification on limitation on maximum number of shareholders)

(59) Sec. 1253 (relating to attribution rules applicable to tenant ownership)

(60) Sec. 1256 relating to modification of earnings and profits rules for determining whether REIT has earnings and profits from non-REIT years)

(61) Sec. 1257 (relating to treatment of foreclosure property)

(62) Sec. 1261 (relating to shared appreciation mortgages)

(63) Sec. 1302 (relating to clarification of waiver of certain rights of recovery)

(64) Sec. 1303 (relating to transitional rule under section 2056A)

(65) Sec. 1304 (relating to treatment for estate tax purposes of short-term obligations held by nonresident alien)

(66) Sec. 1311 (relating to clarification of treatment of survivor annuities under qualified terminable interest rules)

(67) Sec. 1312 (relating to treatment of qualified domestic trust rules of forms of ownership which are not trusts)

(68) Sec. 1313 (relating to opportunity to correct failures under section 2032A)

(69) Sec. 1414 (relating to fermented material from any brewery may be received at a distilled spirits plant)

(70) Sec. 1417 (relating to use of additional ameliorating material in certain wines)

(71) Sec. 1418 (relating to domestically produced beer may be withdrawn free of tax for use of foreign embassies, legations, etc.)

(72) Sec. 1421 (relating to transfer to brewery of beer imported in bulk without payment of tax)

(73) Sec. 1422 (relating to transfer to bonded wine cellars of wine imported in bulk without payment of tax)

(74) Sec. 1506 (relating to clarification of certain rules relating to employee stock ownership plans of S corporations)

(75) Sec. 1507 (relating to modification of 10 percent tax for nondeductible contributions)

(76) Sec. 1523 (relating to repeal of application of unrelated business income tax to ESOPs)

(77) Sec. 1530 (relating to gratuitous transfers for the benefit of employees)

(78) Sec. 1532 (relating to special rules relating to church plans)

(79) Sec. 1604(c)(2) (relating to amendment related to Omnibus Budget Reconciliation Act of 1993)

Line Item Veto Action

Pursuant to the authority under the Line Item Veto Act, the President canceled the following from the above listed items: item (30) Sec. 968 (relating to nonrecognition of gain on sale of stock to certain farmers' cooperatives) and item (54) Sec. 1175 (relating to exemption for active financing income).[317a]

[317a] See House Document 105–116, *Cancellation of Limited Tax Benefit,* Message from the President of the United States. A bill that would restore and modify these canceled provisions, H.R. 2513, was reported by the House Committee on Ways and Means (Rept. 105–318 Part 1) on October 9, 1997, and passed by the House on November 8, 1997.

PART THREE: REVENUE PROVISIONS OF THE BALANCED BUDGET ACT OF 1997 (H.R. 2015)[318]

A. Taxation of Medicare+Choice Medical Savings Accounts (sec. 4006 of the Act and new sec. 138 of the Code)

Present and Prior Law

Under present and prior law, the value of Medicare coverage and benefits is not includible in taxable income.

Individuals who itemize deductions may deduct amounts paid during the taxable year (if not reimbursed by insurance or otherwise) for medical expenses of the taxpayer and the taxpayer's spouse and dependents (including expenses for insurance providing medical care) to the extent that the total of such expenses exceeds 7.5 percent of the taxpayer's adjusted gross income ("AGI").

Within limits, contributions to a medical savings account ("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.[319] Under prior law, individuals covered under Medicare were not eligible to have an MSA.

Earnings on amounts in an MSA are not currently includible in income. Distributions from an MSA for medical expenses of the MSA account holder and his or her spouse or dependents are not includible in income. For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation coverage (so-called "COBRA coverage"), or premiums for coverage while an individual is receiving unemployment compensation. 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.

Under prior law, there were no tax provisions for Medicare+Choice medical savings accounts ("Medicare+Choice MSAs").

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[318] P.L. 105–33; August 5, 1997. H.R. 2015 was reported by the House Committee on the Budget on June 24, 1997 (H. Rept. 105–149). The Committee on Ways and Means approved its health and human resources reconciliation provisions on June 9 and 10, 1997, respectively, which were incorporated in H.R. 2015 as reported. The bill, as amended, was passed by the House on June 25, 1997.

S. 947 was reported by the Senate Committee on the Budget on June 20, 1997 (no written report). S. 947 included the health and human resources reconciliation provisions as approved by the Committee on Finance on June 18, 1997. S. 947 was considered by the Senate on June 23 and 24, 1997, and was passed, as amended, on June 25, 1997.

H.R. 2015, as amended by the Senate provisions of S. 947, was passed by the Senate on June 25, 1997. A conference report was filed in the House on July 30, 1997 (H. Rept. 105–217); the House agreed to the conference report on July 30, 1997; and the Senate agreed to the conference report on July 31, 1997. H.R. 2015 was signed by the President on August 5, 1997.

H.R. 2015, as enacted, includes the revenue-related provisions described in this Part.

[319] The number of MSAs which can be established is subject to a cap.

Explanation of Provision

In general

Under the Act, individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a Medicare+Choice MSA plan.[320] To the extent an individual chooses such a plan, the Secretary of Health and Human Services makes a specified contribution directly into a Medicare+Choice MSA designated by such individual. Only contributions by the Secretary of Health and Human Services can be made to a Medicare+Choice MSA and such contributions are not included in the taxable income of the Medicare+Choice MSA holder. Income earned on amounts held in a Medicare+Choice MSA are not currently includible in taxable income. Withdrawals from a Medicare+Choice MSA are excludable from taxable income if used for the qualified medical expenses of the Medicare+Choice MSA holder. Medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Withdrawals from a Medicare+Choice MSA that are not used for the qualified medical expenses of the account holder are includible in income and may be subject to an additional tax (described below).

Definition of Medicare+Choice MSAs

In general, a Medicare+Choice MSA is an MSA that is designated as Medicare+Choice MSA and to which the only contributions that can be made are those by the Secretary of Health and Human Services.[321] Thus, a Medicare+Choice MSA is a tax-exempt trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account holder that meets requirements similar to those applicable to individual retirement arrangements ("IRAs").[322] The trustee of a Medicare+Choice MSA can be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person will administer the trust will be consistent with applicable requirements.

A Medicare+Choice MSA trustee is required to make such reports as may be required by the Secretary of the Treasury. A $50 penalty is imposed for each failure to file without reasonable cause.

Taxation of distributions from a Medicare+Choice MSA

Distributions from a Medicare+Choice MSA that are used to pay the qualified medical expenses of the account holder are excludable from taxable income regardless of whether the account holder is enrolled in the Medicare+Choice MSA plan at the time of the dis-

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[320] As under prior law, individuals who are eligible for Medicare are not eligible for an MSA that is not a Medicare+Choice MSA.

[321] Medicare+Choice MSAs are not taken into account for purposes of the cap on non-Medicare+Choice MSAs, nor are they subject to that cap.

[322] For example, no Medicare+Choice MSA assets could be invested in life insurance contracts, Medicare+Choice MSA assets can not be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in a Medicare+Choice MSA would be nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to a Medicare+Choice MSA or pledges assets in a Medicare+Choice MSA, rules similar to those for IRAs would apply, and any amounts treated as distributed to the account holder under such rules would be treated as not used for qualified medical expenses.

tribution.[323] Qualified medical expenses are defined as under the rules relating to the itemized deduction for medical expenses. However, for this purpose, qualified medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation insurance (so-called "COBRA coverage"), or premium for coverage while an individual is receiving unemployment compensation. Distributions from a Medicare+Choice MSA that are excludable from gross income under the provision can not be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses are includible in taxable income. An additional tax of 50 percent applies to the extent the total distributions for purposes other than qualified medical expenses in a taxable year exceed the amount by which the value of the Medicare+Choice MSA as of December 31, of the preceding year exceeds 60 percent of the deductible of the plan under which the individual is covered on January 1 of the current year. The additional tax does not apply to distributions on account of the disability or death of the account holder.

Following is an example of how the amount available to be withdrawn from a Medicare+Choice MSA without penalty is calculated.[324]

	Year 1	Year 2	Year 3	Year 4
1. Deductible	$3,000	$3,000	$3,000	$3,000
2. 60% of deductible	1,800	1,800	1,800	1,800
3. Contributions	1,300	1,300	1,300	1,300
4. Earnings	130	200	300	400
5. Total withdrawals	600	500	600	600
6. Closing balance (Dec. 31 of current year)	830	1,830	2,830	3,930
7. Amount available for non-medical withdrawal without penalty (6. from prior year—2., or 0 if less than 0)	0	0	30	1,030

Direct trustee-to-trustee transfers can be made from one Medicare+Choice MSA to another Medicare+Choice MSA without income inclusion.

The provision includes a correction mechanism so that if contributions for a year are erroneously made by the Secretary of Health and Human Services, such erroneous contributions can be returned to the Secretary of Health and Human Services (along with any attributable earnings) from the Medicare+Choice MSA without tax consequence to the account holder.

Treatment of Medicare+Choice MSA at death

Upon the death of the account holder, if the beneficiary of the Medicare+Choice MSA is the account holder's surviving spouse, the surviving spouse may continue the Medicare+Choice MSA, but no

[323] Under the provision, medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses.

[324] The numbers are provided for illustrative purposes only.

new contributions could be made. Distributions from the Medicare+Choice MSA are subject to the rules applicable to MSAs that are not Medicare+Choice MSAs. Thus, earnings on the account balance are not currently includible in income. Distributions from the account for the qualified medical expenses of the spouse or the spouse's dependents (or subsequent spouse) are not includible in income. Distributions not for such medical expenses are includible in income, and subject to a 15-percent excise tax unless the distribution is made after the surviving spouse attains age 65, dies, or becomes disabled.

If the beneficiary of a Medicare+Choice MSA is not the account holder's spouse, the Medicare+Choice MSA is no longer treated as a Medicare+Choice MSA and the value of the Medicare+Choice MSA on the account holder's date of death is included in the taxable income of the beneficiary for the taxable year in which the death occurred (under the rules applicable to MSAs generally). If the account holder fails to name a beneficiary, the value of the Medicare+Choice MSA on the account holder's date of death is to be included in the taxable income of the account holder's final income tax return (under the rules applicable to MSAs generally).

In all cases, the value of the Medicare+Choice MSA is included in the account holder's gross estate for estate tax purposes.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1998.

Revenue Effect

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

B. Tax Treatment of Hospitals Which Participate in Provider-Sponsored Organizations (sec. 4041 of the Act and new sec. 501(o) of the Code)

Present and Prior Law

To qualify as a charitable tax-exempt organization described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international sports competition, or for the prevention of cruelty to children or animals. Although section 501(c)(3) does not specifically mention furnishing medical care and operating a nonprofit hospital, such activities have long been considered to further charitable purposes, provided that the organization benefits the community as a whole.

No part of the net earnings of a 501(c)(3) organization may inure to the benefit of any private shareholder or individual. No substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. In addition, under section 501(m), an organization described in section 501(c)(3) or 501(c)(4) is exempt from

tax only if no substantial part of its activities consists of providing commercial-type insurance.

A tax-exempt organization may, subject to certain limitations, enter into a joint venture or partnership with a for-profit organization without affecting its tax-exempt status. Under current ruling practice, the IRS examines the facts and circumstances of each arrangement to determine (1) whether the venture itself and the participation of the tax-exempt organization therein furthers a charitable purpose, and (2) whether the sharing of profits and losses or other aspects of the arrangement entail improper private inurement or more than incidental private benefit.[325]

Explanation of Provision

The provision provides that an organization does not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of Code section 501(c)(3) solely because a hospital which is owned and operated by such organization participates in a provider-sponsored organization ("PSO") (as defined in section 1845(a)(1) of the Social Security Act), whether or not such PSO is exempt from tax. Thus, participation by a hospital in a PSO (whether taxable or tax-exempt) is deemed to satisfy the first part of the inquiry under current IRS ruling practice.[326]

The provision does not change present-law restrictions on private inurement and private benefit. However, the provision provides that any person with a material financial interest in such a PSO shall be treated as a private shareholder or individual with respect to the hospital for purposes of applying the private inurement prohibition in Code section 501(c)(3). Accordingly, the facts and circumstances of each PSO arrangement are evaluated to determine whether the arrangement entails impermissible private inurement or more than incidental private benefit (e.g., where there is a disproportionate allocation of profits and losses to the non-exempt partners, the tax-exempt partner makes loans to the joint venture that are commercially unreasonable, the tax-exempt partner provides property or services to the joint venture at less than fair market value, or a non-exempt partner receives more than reasonable compensation for the sale of property or services to the joint venture).

The provision does not change present-law restrictions on lobbying and political activities. In addition, the restrictions of Code section 501(m) on the provision of commercial-type insurance continue to apply.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

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[325] See IRS General Counsel Memorandum 39862; Announcement 92–83, 1992–22 I.R.B. 59 (IRS Audit Guidelines for Hospitals). Even where no prohibited private inurement exists, however, more than incidental private benefit 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).

[326] The qualification of a hospital as a tax-exempt charitable organization under section 501(c)(3) is determined as under present law. See Rev. Rul. 69–545, 1969–2 C.B. 117.

Revenue Effect

The provision is estimated to have a negligible revenue effect on Federal fiscal year budget receipts in each of 1997 through 2007.

C. Provision of Employer Identification Numbers by Medicare Providers (sec. 4313 of the Act)

Present Law

Entities participating in Medicare, Medicaid and the Maternal and Child Health Block Grant programs are required to provide certain information regarding the identity of each person with an ownership or control interest in the entity or in any subcontractor in which the entity has a direct or indirect 5 percent or more ownership interest. Providers under part B of Medicare also are required to provide information regarding persons with an ownership or control interest in a provider or any subcontractor in which the provider has a direct or indirect 5 percent or more ownership interest.

Explanation of Provision

The Act requires that all Medicare providers supply the Secretary of HHS with the employer identification number ("EIN") of each disclosing entity, each person with an ownership or control interest, and any subcontractor in which the entity has a direct or indirect 5 percent or more ownership interest. The Secretary of HHS is required to transmit to the Secretary of the Treasury the EIN's received, and the Secretary of the Treasury is directed to verify or correct the EINs. The Secretary of HHS is to reimburse the Secretary of the Treasury for the costs incurred in performing the verification and correction.

Effective Date

The provision is effective 90 days after the Secretary of HHS submits to the Congress a report on the steps taken to ensure the confidentiality of social security account numbers required to be provided to the Secretary of HHS.

Revenue Effect

The provision is estimated to have a negligible effect on fiscal year budget receipts in each of 1997 through 2007.

D. Disclosure of Tax Return Information for Verification of Employment Status of Medicare Beneficiaries and the Spouse of a Medicare Beneficiary (sec. 4631(c) of the Act and sec. 6103(l)(12) of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprison-

ment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure of taxpayer filing status and identity information for the purpose of verifying the employment status of Medicare beneficiaries and the spouse of a Medicare beneficiary.

The Medicare disclosure provision was generally scheduled to expire after September 30, 1998.

Explanation of Provision

The Act permanently extends the Medicare disclosure provision.

Effective Date

The provision is effective on the date of enactment (August 5, 1997).

Revenue Effect

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

E. Unemployment Tax Provisions

1. Exemption from service performed by election workers from the Federal Unemployment Tax (sec. 5405 of the Act and sec. 3309(b) of the Code)

Present Law

The Federal Unemployment Tax Act ("FUTA") generally requires States to cover under their unemployment compensation laws service performed in the employ of a State or local government. Only certain enumerated exceptions are allowed.

Reasons for Change

The Congress believes that short-term employment as an election official or election worker should not form the basis for participation in the unemployment compensation system.

Explanation of Provision

The Act exempts from FUTA service performed as an election official or election worker. This exemption applies only if the annual wages received by the individual for such service are less than $1,000. These persons are also ineligible to claim unemployment benefits with respect to such wages.

Effective Date

The provision was effective with respect to service performed after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $1 million in 1998 and have a negligible effect on Federal fiscal year budget receipts thereafter.

2. Treatment of certain services performed by inmates (sec. 5406 of the Act and sec. 3306 of the Code)

Present and Prior Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 of wages paid annually by covered employers to each employee. Generally, wages are defined to include all remuneration for employment unless specifically exempted. Under prior law, there was no exemption for wages paid to persons committed to penal institutions who earn wages through private-sector jobs.

Reasons for Change

The Congress believed that employment while committed to penal institutions should not form the basis for participation in the unemployment compensation system.

Explanation of Provision

The Act exempts wages paid to persons committed to penal institutions from the definition of wages for FUTA tax purposes. These persons are also ineligible to claim unemployment benefits with respect to such wages.

Effective Date

The provision was effective with respect to service performed after January 1, 1994.

Revenue Effect

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

3. Exemption of service performed for an elementary or secondary school operated primarily for religious purposes from the Federal unemployment tax (sec. 5407 of the Act and sec. 3309(b) of the Code)

Present and Prior Law

The Federal Unemployment Tax Act ("FUTA") requires States to cover under their unemployment compensation laws certain nonprofit organizations designated under FUTA that are not subject to the FUTA tax. These nonprofit organizations generally must elect whether to pay State unemployment taxes or reimburse the State unemployment insurance agency for the benefits provided to its former employees. However, FUTA exempts from coverage under State unemployment compensation laws service performed in the employ of: (1) a church or convention or association of churches, or (2) an organization which is operated primarily for religious pur-

poses and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches. Under prior law, services provided by individuals who are in the employ of entities with a religious orientation which are not affiliated with a particular church, or convention or association of churches were not exempt from State unemployment compensation laws.

Reasons for Change

The Congress believed that employees of certain schools with a religious orientation should be treated similarly for FUTA tax purposes regardless of the school's affiliation, or lack thereof, with a particular church, or convention, or association of churches.

Explanation of Provision

The Act exempts from FUTA requirements of coverage under State unemployment compensation laws service performed in an elementary or secondary school which is operated primarily for religious purposes. This exemption is available to such schools even though they are not operated, supervised, controlled, or principally supported by a church or convention or association of churches. Persons performing such service are also ineligible to claim unemployment benefits with respect to such wages

Effective Date

The provision was effective with respect to service performed after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by $2 million in fiscal year 1998 and have a negligible revenue effect thereafter.

F. Earned Income Credit Provision

1. Authorization of appropriations for enforcement initiatives related to the earned income credit (sec. 5702)

Present Law

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. 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 earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is reduced by the amount of the alternative minimum tax ("AMT") the taxpayer owes for the year. The credit is phased out above certain income levels.

The Taxpayer Relief Act of 1997 modified the Code to include several earned income credit compliance initiatives. Prior to fiscal year 1998 however, there was no explicit authorization of appropriations for the enforcement of the earned income credit.

Reasons for Change

The Congress believes that this provision will lead to better enforcement of the earned income credit.

Explanation of Provision

The Act authorizes to be appropriated to the Secretary of the Treasury for improved application of the earned income credit, the following amounts: $138 million in FY 1998, $143 million in FY 1999, $144 million in FY 2000, $145 million in FY 2001, and $146 million in FY 2002.

Effective Date

The provision was effective on the date of enactment (August 5, 1997).

Revenue Effect

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

G. Increase in Excise Tax on Tobacco Products (sec. 9302 of the Act, sec. 1604(f)(3) of the Taxpayer Relief Act of 1997, and sec. 5701 of the Code)

Present Law

The following is a listing of the Federal excise tax rates imposed on tobacco products under present law (through December 31, 1999):

Article	Tax rate
Cigars:	
Small cigars	$1.125 per thousand.
Large cigars	12.75% of manufacturer's price, up to $30 per thousand.
Cigarettes:	
Small cigarettes	$12.00 per thousand (24 cents per pack of 20 cigarettes).
Large cigarettes	$25.20 per thousand.
Cigarette papers	$0.0075 per 50 papers.
Cigarette tubes	$0.15 per 50 tubes.
Chewing tobacco	$0.12 per pound.
Snuff	$0.36 per pound.
Pipe tobacco	$0.675 per pound.

Reasons for Change

The Congress determined that it is appropriate to increase excise taxes on tobacco products, and to extend the tax to "roll-your-own" tobacco. Raising such taxes will have the positive effect of discouraging smoking, particularly by children and teenagers.

Explanation of Provision

In general

The Act increases the current excise tax rates on all tobacco products, including cigarettes, cigars, chewing tobacco, snuff, and pipe tobacco, effective in two stages: January 1, 2000 and January 1, 2002. Excise tax is also imposed on "roll-your-own" tobacco, beginning in 2000. Floor stocks taxes are imposed on tobacco products at the time of the rate increases (including tobacco products in foreign trade zones). The Act also includes expanded compliance measures designed to prevent diversion of non-tax-paid tobacco products nominally destined for export to use within the United States.

Specific tax rate increases

Tax rates for 2000 and 2001

The following table shows the specific tobacco excise tax rates under the Act in effect for the period, January 1, 2000–December 31, 2001:

Article	Tax rate (January 1, 2000–December 31, 2001)
Cigars:	
Small cigars	$1.594 per thousand.
Large cigars	18.063% of manufacturer's price, up to $42.50 per thousand.
Cigarettes:	
Small cigarettes	$17.00 per thousand (34 cents per pack of 20 cigarettes).
Large cigarettes	$35.70 per thousand.
Cigarette papers	$0.0106 per 50 papers.
Cigarette tubes	$0.0213 per 50 tubes.
Chewing tobacco	$0.17 per pound.
Snuff	$0.51 per pound.
Pipe tobacco	$0.9567 per pound.
Roll-your-own tobacco	$0.9567 per pound.

Tax rates for 2002 and thereafter

The following table shows the specific tobacco excise tax rates in effect for 2002 and thereafter:

Article	Tax rate (2002 and thereafter)
Cigars:	
Small cigars	$1.828 per thousand.
Large cigars	20.719% of manufacturers price, up to $48.75 per thousand.
Cigarettes:	
Small cigarettes	$19.50 per thousand (39 cents per pack of 20 cigarettes).
Large cigarettes	$40.95 per thousand.
Cigarette papers	$0.0122 per 50 papers.
Cigarette tobacco	$0.0244 per 50 tubes.
Chewing tobacco	$0.19 cents per pound.
Snuff	$0.585 cents per pound.
Pipe tobacco	$1.0969 per pound.
Roll-your-own tobacco	$1.0969 per pound.

Coordination with tobacco industry settlement agreement

Section 1604(f)(3) of the Taxpayer Relief Act of 1997 provided that the increase in tobacco excise taxes collected as a result of the above increases are to be "credited against the total payments made by parties pursuant to Federal legislation implementing the tobacco industry settlement agreement of June 20, 1997."[327]

Effective Date

The provision generally is effective on January 1, 2000.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $1,175 million in 2000, $1,720 million in 2001, $2,272 million in 2002, $2,280 million in 2003, $2,290 million in 2004, $2,300 million in 2005, $2,310 million in 2006, and $2,320 million in 2007.

H. Identification of Limited Tax Benefits Subject to Line Item Veto (sec. 9304 of the Act)

Present and Prior Law

The Line Item Veto Act amended the Congressional Budget and Impoundment Act of 1974 to grant the President the limited authority to cancel specific dollar amounts of discretionary budget authority, certain new direct spending, and limited tax benefits. The

[327] This provision was repealed under section 519 of the Fiscal Year 1998 Appropriations for Labor, Health and Human Resources (H.R. 2264) as passed by the Congress and signed by the President (P.L. 105–78, November 13, 1997).

Line Item Veto Act provides that the Joint Committee on Taxation is required to examine any revenue or reconciliation bill or joint resolution that amends the Internal Revenue Code of 1986 prior to its filing by a conference committee in order to determine whether or not the bill or joint resolution contains any limited tax benefits and to provide a statement to the conference committee that either (1) identifies each limited tax benefit contained in the bill or resolution, or (2) states that the bill or resolution contains no limited tax benefits. The conferees determine whether or not to include the Joint Committee's statement in the conference report. If the conference report includes the information from the Joint Committee on Taxation identifying provisions that are limited tax benefits, then the President may cancel one or more of those, but only those, provisions that have been identified. If such a conference report contains a statement from the Joint Committee on Taxation that none of the provisions in the conference report are limited tax benefits, then the President has no authority to cancel any of the specific tax provisions, because there are no tax provisions that are eligible for cancellation under the Line Item Veto Act.

Explanation of Provision

The Balanced Budget Act of 1997 contains a provision that has been identified by the Joint Committee on Taxation as a limited tax benefit within the meaning of the Line Item Veto Act. The provision is section 5406 of the Balanced Budget Act, relating to treatment of certain services performed by inmates.

PART FOUR: TAXPAYER BROWSING PROTECTION ACT (H.R. 1226)[328]

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 willful 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).

There is no explicit criminal penalty in the Internal Revenue Code for unauthorized inspection (absent subsequent disclosure) of tax returns and return information. Such inspection is, however, explicitly prohibited by the Internal Revenue Service ("IRS").[329] In a recent case, an individual was convicted of violating the Federal wire fraud statute (18 U.S.C. 1343 and 1346) and a Federal computer fraud statute (18 U.S.C. 1030) for unauthorized inspection. However, the U.S. First Circuit Court of Appeals overturned this conviction.[330] Unauthorized inspection of information of any department or agency of the United States (including the IRS) via computer was made a crime under 18 U.S.C. 1030 by the Economic Espionage Act of 1996.[331] This provision does not apply to unauthorized inspection of paper documents.

Reasons for Change

The Congress believed that it is important to have a criminal penalty in the Internal Revenue Code to punish this type of behavior. The Congress also believed that it is appropriate to provide for civil damages for unauthorized inspection parallel to civil damages for unauthorized disclosure.

Explanation of Provisions

Criminal penalties (sec. 2 of the Act and new sec. 7213A of the Code)

The Act creates a new criminal penalty in the Internal Revenue Code. The penalty is imposed for willful inspection (except as authorized by the Code) of any tax return or return information by any Federal employee or IRS contractor. The penalty also applies to willful inspection (except as authorized) by any State employee

[328] P.L. 105–35; August 5, 1997. H.R. 1226 was reported by the House Committee on Ways and Means on April 14, 1997 (H. Rept. 105–51). The bill, as amended, passed the House on April 15, 1997, and was passed by the Senate on July 23, 1997. H.R. 1226 was signed by the President on August 5, 1997.

[329] IRS Declaration of Privacy Principles, May 9, 1994.

[330] *U.S.* v. *Czubinski,* DTR 2/25/97, p. K–2.

[331] P.L. 104–294, sec. 201 (October 11, 1996).

or other person who acquired the tax return or return information under specific provisions of section 6103. Upon conviction, the penalty is a fine in any amount not exceeding $1,000,[332] or imprisonment of not more than 1 year, or both, together with the costs of prosecution. In addition, upon conviction, an officer or employee of the United States would be dismissed from office or discharged from employment.

The Congress viewed any unauthorized inspection of tax returns or return information as a very serious offense; this new criminal penalty reflects that view. The Congress also believed that unauthorized inspection warrants very serious personnel sanctions against IRS employees who engage in unauthorized inspection, and that it is appropriate to fire employees who do this.

Civil damages (sec. 3 of the Act and sec. 7431 of the Code)

The Act amends the provision providing for civil damages for unauthorized disclosure by also providing for civil damages for unauthorized inspection. Damages are available for unauthorized inspection that occurs either knowingly or by reason of negligence. Accidental or inadvertent inspection that may occur (such as, for example, by making an error in typing in a TIN) would not be subject to damages because it would not meet this standard. The Act also provides that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The Act also requires that, if any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of section 7213 (a) or (b), new section 7213A (as added by the Act), or 18 USC section 1030(a)(2)(B), the Secretary notify that taxpayer as soon as practicable of the inspection or disclosure.

Effective Date

The Act is effective for violations occurring on or after the date of enactment (August 5, 1997).

Revenue Effect

The provision is estimated to increase Federal fiscal year budget receipts by less than $1 million per year in 1997 through 2007.

[332] Pursuant to 18 U.S.C. sec. 3571 (added by the Sentencing Reform Act of 1984), the amount of the fine is not more than the greater of the amount specified in this new Code section or $100,000.

PART FIVE: EXTENSION OF HIGHWAY TRUST FUND (S. 1519)[333]

(Sec. 9 of S. 1519 and secs. 9503, 9504(c) and 9511(c) of the Code)

Prior Law

Under prior law, the Internal Revenue Code (sec. 9503) authorized expenditures (subject to appropriations) to be made from the Highway Trust Fund through September 30, 1997, for purposes provided in specified authorizing legislation as in effect on the date of enactment of the most recent authorizing Act (the Intermodal Surface Transportation Efficiency Act of 1991).[334]

Highway Trust Fund provisions also provided for transfer of 11.5 cents per gallon of the revenues from the excise tax imposed on motor fuels used in motorboats and off-highway recreational vehicles. Those revenues were transferred from the Highway Trust Fund to the Boat Safety Account of the Aquatic Resources Trust Fund (up to $70 million per year), the Land and Water Conservation Fund ($1 million per year), and the National Recreational Trails Trust Fund, respectively, through September 30, 1997.[335] Revenues from the gasoline tax used in small engines were transferred to the Sport Fish Restoration Account of the Aquatic Resources Trust Fund through September 30, 1997. Expenditures were and are authorized from the Boat Safety Account of the Aquatic Resources Trust Fund through March 31, 1998. Expenditures were authorized from the National Recreational Trails Trust Fund through September 30, 1997.

Reasons for Change

The Congress extended Highway Trust Fund program authorizations for 6 months in this Act ("Surface Transportation Extension Act of 1997"), and determined that the Highway Trust Fund expenditure authority needed to be extended and updated to reflect the expenditure purposes authorized under this Act during fiscal year 1998.

Explanation of Provision

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through September

[333] P.L. 105–130; December 1, 1997 (Section 9 of the Surface Transportation Extension Act of 1997). S. 1519 was passed by the Senate on November 10, 1997, and by the House on November 12, 1997. The Act was signed by the President on December 1, 1997.

[334] The other authorizing Acts referenced in the Highway Trust Fund are the Highway Revenue Act of 1956, Titles I and II of the Surface Transportation Assistance Act of 1982, and the Surface Transportation and Uniform Relocation Act of 1987.

[335] No amounts have actually been transferred yet to the National Recreational Trails Trust Fund because no obligations have been made for that Trust Fund.

30, 1998. The Act also updates the Highway Trust Fund cross reference to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

In addition, the Act extends the deadline for the transfer from the Highway Trust Fund of revenues from the tax on gasoline and special motor fuels used in motorboats, gasoline used in small engines, and motor fuels used in off-highway recreational vehicles through September 30, 1998. Further, the Act extends the expenditure authority from the Boat Safety Account of the Aquatic Resources Trust Fund for 6 months, through September 30, 1998, and extends the expenditure authority from the National Recreational Trails Trust Fund through September 30, 1998.[336]

Effective Date

The provision was effective on October 1, 1997.

Revenue Effect

The provision has no effect on Federal fiscal year budget receipts.

[336] This Act includes an authorization from the Highway Trust Fund for the National Recreational Trails Program.

APPENDIX

APPENDIX:

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
PART ONE: AIRPORT AND AIRWAY TRUST FUND EXTENSION ACT OF 1997 (H.R. 668)													
1. Extension of Airport and Airway Trust Fund excise taxes through 9/30/97	tp 7 data DOE	2,730	−54										2,676
Subtotal: H.R. 668		**2,730**	**−54**										**2,676**
PART TWO: TAXPAYER RELIEF ACT OF 1997 (H.R. 2014)													
Title I. Child Tax Credit													
A. Tax Credit for Children Under Age 17 ($400 in 1998, and $500 thereafter: $75,000/$110,000 AGI phaseout for credit; nonrefundable for small families, refundable and limited to tax plus employee FICA minus EIC for large families) (1)(2)	tyba 12/31/97		−2,710	−18,119	−21,549	−21,401	−21,258	−20,901	−20,430	−19,702	−18,997	−18,317	−183,384
B. Expand Definition of High-Risk Individuals with Respect to Tax-Exempt State-Sponsored Organizations Providing Health Coverage	tyba 12/31/97		−1	−2	−2	−2	−2	−2	−2	−2	−2	−2	−17

Title II. Education Tax Incentives													
A. Tax Benefits Relating to Education Expenses													
1. HOPE credit, 100% credit for first $1,000 of eligible expenses, 50% credit for next $1,000, 20% credit for third and fourth year students for up to $5,000 of expenses; for years after 2002, expenses are increased to $10,000 (effective date of the 20% credit is 7/1/98); eligible expenses for HOPE credit are indexed in 2001; income limits for both credits indexed in 2001	pma & tyba 12/31/97	.....	−2,083	−6,469	−7,393	−7,907	−7,707	−8,620	−8,754	−8,893	−9,035	−9,180	−76,041
2. Deduction for student loan interest: $1,000 above-the-line deduction in 1998, $1,500 in 1999, $2,000 in 2000, $2,500 in 2001 and thereafter; phaseout $40,000—$55,000 single filers ($60,000—$75,000 joint filers); income limits indexed beginning in 2003	poida 12/31/97	.....	−18	−69	−122	−204	−277	−308	−326	−346	−368	−391	−2,429
3. Penalty-free withdrawals from IRAs for undergraduate, post-secondary vocational, and graduate education expenses	da 12/31/97	.....	−78	−201	−181	−175	−177	−179	−182	−184	−186	−189	−1,732
4. Expand State-sponsored prepaid tuition and State savings programs to include room and board (3)	tyba 12/31/97	.....	−36	−107	−118	−130	−143	−157	−173	−190	−209	−230	−1,491

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
5. Education IRA—permit contributions to Education IRA for a child under age 18; annual contributions limited to $500 per child; impose phaseout range of $95,000–$110,000 for single filers and $150,000–$160,000 for joint filers (4)	tyba 12/31/97	.....	−156	−644	−912	−1,060	−1,126	−1,448	−1,752	−2,054	−2,360	−2,680	−14,193
B. Other Education-Related Tax Provisions													
1. Extend employer-provided education assistance for undergraduates through 5/31/00 (1)	tyba 12/31/96	.....	−534	−369	−250	.....	.....	.....	.....	.....	.....	.....	−1,153
2. Repeal $150 million limit on tax-exempt section 501(c)(3) bonds for new capital expenditures	bia DOE	.....	−6	−45	−75	−89	−99	−106	−115	−125	−138	−162	−962
3. Raise small issuer arbitrage rebate exception for governmental bonds used to finance education facilities from $5 million to $10 million	bia 12/31/97	.....	−1	−4	−7	−11	−14	−27	−30	−33	−36	−38	−199
4. Enhanced deduction for corporate contributions of computer technology and equipment for grades K–12; sunset after 3 years	tyba 12/31/97	.....	−46	−48	−77	−49	−5	−1	.....	.....	.....	.....	−227
5. Treatment of cancellation of certain student loans	Doia DOE	.....	.....	.....	.....	Negligible Revenue Effect	.....	.....	.....	.....	.....	.....	.....

6. Tax credit for holders of qualified education bonds (limited to $400 million per year in loans); 2-year sunset	qza bia 12/31/97	−8	−27	−43	−47	−47	−47	−47	−47	−47	−47	−408
Title III. Savings and Investment Tax Incentives												
A. Individual Retirement Arrangements—Increase deductible IRA income limits by $10,000 for joint filers in 1998 ($5,000 for single filers in 1998) and by $1,000 per year through 2002; in 2003 increase to $40,000 for single filers and $60,000 for joint filers and by $5,000 per year thereafter until limits are $50,000–$60,000 for single filers and $80,000–$100,000 for joint filers (phase out range increases to $20,000 when lower limit reaches $100,000); penalty-free withdrawals for educational purposes and first-time home purchase only; create Roth IRA; impose phase-out range of $95,000–$110,000 for single filers and $150,000–$160,000 for joint filers; impose $150,000–$160,000 income phase-out for spousal IRAs; provide that aggregate contributions to deductible and nondeductible retirement IRAs may not exceed $2,000	tyba 12/31/97	−367	−345	86	−346	−860	−1,830	−3,292	−3,482	−4,424	−5,004	−20,225

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
B. Capital Gains Provisions: (a) 20%/10% rate structure; (b) retain 28%/15% for collectibles, includible gain from small business stock, and assets held more than 1 year but not more than 18 months; (c) 25% maximum rate for unrecaptured section 1250 gain; (d) 18%/8% for assets held more than 5 years after 2000, with mark-to-market in 2001; assets qualify for 18% only if purchased after 2000; (e) symmetric AMT rates; (f) exclusion of gain on personal residences (including remainder interests); (g) no information reporting on sales of principal residences less than $250,000 or $500,000 (married filing joint return); (h) tax-free rollover of qualified small business stock held more than 6 months by individuals; and (i) corporate alternative rate limited to taxable income	various (5)	1,254	6,371	171	−2,954	−2,934	−1,785	−3,742	−3,981	−4,179	−4,424	−4,958	−21,161
Title IV. Alternative Minimum Tax Provisions													
A. Repeal Alternative Minimum Tax for Small Businesses and Modify the Depreciation Adjustment													
1. Repeal of the alternative minimum tax for small corporations	tyba 12/31/97		−97	−171	−131	−100	−77	−59	−45	−34	−26	−20	−762

2. Conform AMT depreciation lives to the regular tax	ppisa 12/31/98	.....	.....	−580	−1,653	−2,230	−2,358	−2,561	−2,622	−2,350	−2,044	−1,920	−18,317
B. Repeal AMT Installment Method Adjustment for Farmers	di tyba 12/31/87	−8	−157	−158	−167	−164	−157	−148	22	22	21	21	−872
Title V. Estate, Gift, and Generation-Skipping Tax Provisions													
A. Estate and Gift Tax Provisions													
1. Increase unified estate and gift tax credit to $625,000 in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005; $1 million in 2006 and thereafter; and index other provisions beginning in 1999; cap family owned business exclusion with unified credit at $1.3 million annually (exclude $675,000 in 1998, $650,000 in 1999, $625,000 in 2000, $625,000 in 2001, $600,000 in 2002 and 2003, $450,000 in 2004, $350,000 in 2005; $300,000 in 2006 and thereafter)	dda 12/31/97	.....	.....	−843	−1,259	−1,816	−2,013	−2,596	−2,997	−5,656	−7,279	−8,638	−33,097
2. Reduce section 6601(j) interest rate to 2% for first $1 million of taxable closely-held business interests, remainder subject to tax at 45% of present-law interest rates, and all interest under section 6166 made nondeductible	dda 12/31/97	.....	.....	−9	−17	−25	−33	−41	−47	−53	−58	−65	−349
3. Extension of treatment of certain rents under section 2032A to lineal descendants	roa 12/31/76	.....	−25	−2	−2	−2	−2	−2	−2	−2	−2	−2	−43
4. Clarification of judicial review of eligibility for extension of time for payment of estate tax	dda DOE	.....	.....	−15	−15	−15	−15	−15	−15	−14	−12	−11	−127

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
5. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations	gma DOE			−16	−18	−21	−26	−32	−38	−45	−53	−61	−310
6. Repeal certain throwback rules applicable to domestic trusts; exclude pre-1984 multiple trusts from repeal	Dmi tyba DOE			−11	−11	−11	−11	−11	−11	−11	−11	−11	−99
7. Provide up to $500,000 estate tax exclusion (phasein by $100,000 annually beginning in 1998) for treatment of land subject to a qualified conservation easement coordinated with exclusion of family farms and business relief (with expanded treatment of land with severed mineral rights)	dda 12/31/97			−7	−15	−25	−35	−48	−51	−56	−60	−64	−361
B. Generation-Skipping Tax Provision													
1. Expand exception from generation-skipping transfer tax for transfers to individuals with deceased parents	gsta 12/31/97			−4	−4	−4	−4	−4	−5	−5	−5	−6	−41
Title VI. Extension of Certain Expiring Tax Provisions													
A. Research Tax Credit (through 6/30/98)	6/1/97	−161	−820	−639	−294	−204	−123	−33					−2,274
B. Contributions of Appreciated Stock to Private Foundations (through 6/30/98)	6/1/97		−99	−9	−4								−112

C. Work Opportunity Tax Credit (through 6/30/98 (6))	wpoifhma 9/30/97		−140	−131	−73	−28	−11	−2					−385
D. Orphan Drug Tax Credit (permanent)	epoia 5/31/97		−29	−28	−30	−32	−34	−35	−37	−39	−40	−42	−346
Title VII. District of Columbia Tax Incentives													
1. Designate existing D.C. enterprise community and census tracts with greater than 20% poverty (with revised residency requirement) as the D.C. Enterprise Zone, eligible for modified present-law empowerment zone incentives (20% wage credit, increased 179 expensing, and expanded tax-exempt financing); sunset 12/31/02	1/1/98		−71	−110	−113	−118	−127	−45	3	2	(7)	−2	−582
2. Provide 0% capital gains rate on enterprise zone business property in D.C. census tracts with greater than 10% poverty held for at least 5 years; sunset 12/31/02	1/1/98		−1	−5	−12	−21	−33	−48	−85	−90	−99	−107	−502
3. $5,000 tax credit for first-time homebuyer in D.C., with phaseout of $110,000–$130,000 for joint filers ($70,000–$90,000 for single filers), and sunset 12/31/00	po/a DOE		−10	−21	−27	−16	(7)	(7)	(7)	(7)	(7)	(7)	−74
Title VIII. Welfare-To-Work Tax Credit													
1. Administration's welfare-to-work tax credit, as modified: (a) wage credit is 35% on first $10,000 of wages in the first year of employment, and 50% on $10,000 of wages in the second year of employment; (b) effective for hires made through 4/30/99	wpoifhma 12/31/97		−13	−31	−29	−15	−10	−4	−2	−1			−106

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
Title IX. Miscellaneous Provisions													
A. Excise Tax Provisions													
1. Transfer of General Fund highway fuels tax revenues to the Highway Trust Fund:													
a. Transfer the 4.3 cents/gallon transportation motor fuels tax on highway motor fuels to the Highway Trust Fund	10/1/97	No Revenue Effect											
b. Modify excise tax deposit rules for gasoline and special motor fuels, diesel fuel and kerosene, aviation fuels, and air cargo taxes to suspend deposits due 8/1/98 to 9/30/98 until 10/5/98	DOE		−6,359	6,359									
2. Repeal excise tax on recreational motorboat diesel fuel	fsa 12/31/97		−4	−5	−5	−1	−1	−1	−1	−1	−1	−1	−22
3. Modify excise tax on imported halons	DOE	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	1
4. Uniform excise tax on vaccines; add 3 new vaccines ($0.75 per dose)	SaDOE		−16	−15	−15	−15	−14	−14	−14	−14	−14	−14	−146
5. Treat certain gasoline retailers as wholesale distributors under gasoline tax refund rules	DOE	Negligible Revenue Effect											
6. Exemption for electric and clean-fuel vehicles from luxury excise tax	saia DOE	(7)	−1	−1	(7)	(7)	(7)	(7)					−2

7. Equalize the excise tax rates among alternative motor fuels except CNG	fsoua 9/30/97	−2	−15	−16	−16	−17	−18	−19	−20	−21	−22	−23	−186
8. Reduce excise tax rate on draft cider to the small producer beer rate	10/1/97	.....	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−7
9. Study feasibility of moving collection point for distilled spirits excise tax	DOE	.....				No Revenue Effect							.....
10. Codify Treasury Department regulations regulating wine labels	DOE	.....				No Revenue Effect							.....
B. Disaster Relief Provisions													
1. Disaster losses—postponement of IRS deadlines; permit extension of statute of limitations	aoty	.....				Negligible Revenue Effect							.....
2. Use of certain appraisals to establish amount of disaster loss	DOE	.....				Negligible Revenue Effect							.....
3. Modify tax treatment of livestock sold on account of certain weather-related conditions	sea 12/31/96	.....	−12	−2	−2	−2	−1	−1	−1	−1	−1	−1	−23
4. Loosen mortgage revenue bond requirements in Presidentially declared disaster areas for 2 years; permit 2-year period to place mortgages	(9)	.....	−3	−7	−8	−8	−7	−6	−6	−5	−4	−4	−58
5. Abatement of interest on underpayments by taxpayers in Presidentially declared disaster areas (1997 disaster areas only)	1/1/97	−5	.....										−5
C. Provisions Relating to Employment Taxes													
1. Worker classification of securities brokers for income and employment tax purposes	spa 12/31/97	.....				Negligible Revenue Effect							.....
2. Clarification of SECA tax treatment of termination payments received by former insurance agents	pa 12/31/97	.....				Negligible Revenue Effect							.....

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
D. Provisions Relating to Small Businesses													
1. Delay penalties for failure to make payments through EFTPS until after 6/30/98	DOE	...	...	...	...	No Revenue Effect				...	...	...	...
2. Home office deduction: definition of principal place of business	tyba 12/31/98	...	...	−119	−244	−253	−263	−274	−285	−295	−306	−318	−2,358
3. 3-year income averaging for farmers	(10)	−1	−10	−53	−54	−50	...	...	...	...	...	...	−168
4. Increase deduction for health insurance expenses of self-employed individuals: 50% in 2000 and 2001, 60% in 2002, 80% in 2003 through 2005; 90% in 2006, and 100% in 2007 and thereafter	tyba 12/31/96	...	...	...	−39	−120	−224	−605	−882	−601	−404	−604	−3,479
5. Impose moratorium on issuance of Treasury regulations relating to self-employment tax (SECA) treatment of limited partners through 6/30/98	DOE	...	...	...	...	No Revenue Effect				...	...	...	...
E. Expense "Brownfields" redevelopment costs in empowerment zones, enterprise communities and EPA demonstration sites; add census tracts with greater than 20% poverty; 3-year sunset	(11)	...	−57	−132	−165	−63	(8)	2	9	17	19	18	−352
F. Empowerment Zones and Enterprise Communities													
1. Designate 20 new urban empowerment zones with modified incentives (12)	DOE	...	−82	−121	−121	−99	−79	−56	−44	−41	−38	−25	−706

2. Designate 2 supplemental empowerment zones as regular empowerment zones, with present-law incentives (phaseout of wage credit beginning in 2004)	1/1/00			−38	−86	−92	−98	−78	−53	−26	−13	−483
3. Modification of empowerment zone and enterprise community criteria in the event of future designations of additional zones and communities	DOE					No Revenue Effect						
G. Other Provisions												
1. Shrinkage allowance for inventory accounting	tyea DOE		−7	−21	−23	−25	−27	−29	−31	−33	−35	−37	−268
2. Include liability to pay compension under workmen's compensation acts within rules relating to certain personal liability assignments	cfa DOE		−1	−2	−5	−8	−12	−17	−23	−29	−32	−36	−164
3. Clarify tax-exempt status of certain State workmen's compensation funds	tyba 12/31/97		(7)	(7)	−1	−1	−1	−1	−1	−1	−1	−1	−6
4. Election for 1987 partnerships to continue exception from treatment of publicly traded partnerhsips as corporations	tyba 12/31/97						Revenue Neutral						
5. Exclusion from UBIT for certain corporate sponsorship payments	psora 12/31/97						Negligible Revenue Effect						
6. Allow timeshare associations to elect to be taxed as homeowner associations at 32% rate and modify definition of property for timeshares	tyba 12/31/96		−1	−1	−1	−1	−2	−2	−2	−2	−2	−2	−17
7. Modification of advance refunding rules for certain tax-exempt bonds issued by the Virgin Islands (13)	DOE		−2	−4	−5	−5	−5	−3	−1	−3	−4	−4	−37

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
8. Deferral of gain on sales of stock in farm product refining firms to farm coops which supply the firm with raw farm products for refining (14)	Sa 12/31/97	.....	−2	−68	−5	−5	−4	−4	−4	−4	−4	−4	−104
9. Increase the business meals deduction to 80% in 5% increments every other year for persons subject to Federal hours of service limitation, with clarification of section 119 meals	tyba 12/31/97	.....	−8	−17	−27	−37	−49	−62	−76	−91	−108	−125	−600
10. Modify limits on depreciation of luxury automobiles for certain clean-burning fuel and electric vehicles	ppisa DOE	.....				Negligible Revenue Effect							.....
11. Suspend 100% net income limitation with respect to percentage depletion on oil and gas property for marginal producers for 2 years	DOE	.....	−21	−35	−14	.....							−70
12. Raise the charitable mileage rate from 12 cents/mile to 14 cents/mile; no indexing	tyba 12/31/97	.....	−8	−56	−58	−61	−64	−68	−71	−75	−78	−82	−621
13. Purchasing of receivables by tax-exempt hospital cooperative service organizations	tyba 12/31/96	.....				Negligible Revenue Effect							.....
14. Provide an above-the-line deduction for certain State and local official's expenses	tyba 12/31/86	.....	−10	−4	−4	−4	−5	−5	−6	−6	−7	−7	−58

15. Combined employment tax reporting demonstration project (5-year demonstration)	DOE						No Revenue Effect						
16. Elective carryback of existing net operating losses of the National Railroad Passenger Corporation (Amtrak)	(15)		−1,162	−1,162									−2,323
H. Extension of Duty-Free Treatment Under the Generalized System of Preferences (through 6/30/98) (16)	DOE	−378											−378
Title X. Revenue-Increase Provisions													
A. Financial Products													
1. Require recognition of gain on certain appreciated positions in personal property; election of mark-to-market for securities traders and for traders and dealers in commodities; limitation on exception for investment companies under section 351	csa 6/8/97		367	121	68	73	79	85	94	111	118	127	1,243
2. Gains or losses from certain terminations with respect to property	30da DOE		15	27	25	25	25	25	25	25	25	25	242
3. Determination of original issue discount where pooled debt obligations subject to acceleration	tyba DOE		76	275	358	319	283	100	105	109	114	118	1,857
4. Deny interest deduction on certain debt instruments	iia 6/8/97		5	16	29	43	55	62	63	64	65	67	469
B. Corporate Organizations and Reorganizations													
1. Require gain recognition for certain extraordinary dividends	da 5/3/95+ 9/13/95		44	−93	−54	−10	45	77	81	89	95	101	375
2. Require gain recognition on certain distributions of controlled corporation stock	da 4/16/97		301	243	216	187	158	130	101	73	46	10	1,465

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
3. Reform tax treatment of certain corporate stock transfers	doaa 6/8/97	.....	10	10	5	5	5	5	5	5	5	5	60
4. Treat certain preferred stock treated as "boot"	ta 6/8/97	.....	35	37	39	41	43	10	10	11	11	12	248
5. Modify holding period for dividends-received deduction with 2-year transition period	droaa 30da DOE	.....	11	13	15	16	16	16	17	17	17	18	156
C. Administrative Provisions													
1. Reporting of certain payments made to attorneys	pma 12/31/97	.....		3	3	3	3	3	4	4	4	4	31
2. Information reporting on persons receiving contract payments from certain Federal agencies	rd 90da DOE	.....		7	8	9	10	11	11	12	12	13	93
3. Disclosure of tax return information for administration of certain Veterans' programs ([16])	DOE	.....		22	27	31	36	36	.....	.....	.....	.....	152
4. Establish IRS continuous levy and improve debt collections	lia DOE	.....	332	327	256	213	157	117	102	86	82	78	1,750
5. Consistency rule for beneficiaries of trusts and estates	rfa DOE	.....	3	3	3	3	3	3	4	4	4	4	34
6. Registration of confidential corporate tax shelters and substantial understatement penalty	tsoaiTg	.....	15	37	38	39	41	42	43	44	46	47	392

D. Excise and Employment Tax Provisions													
1. Extension and modification of Airport and Airway Trust Fund excise taxes:													
a. Extend domestic air passenger ticket tax: reduce tax rate from 10% to 9% of ticket price and impose an additional tax of $1.00 per flight segment for 10/1/97 through 9/30/98; 8% and $2.00/segment for 10/1/98 through 9/30/99; and 7.5% after 9/30/99 with additional tax of $2.25/segment for 10/1/99 through 12/31/99, $2.50/segment in 2000, $2.75/segment in 2001, and $3.00/segment in 2002, and in years thereafter index the $3.00/segment tax to changes in the CPI (first indexing adjustment on 1/1/03)	10/1/97	.....	4,633	4,859	5,031	5,433	5,870	6,275	6,684	7,117	7,580	8,059	61,542
b. Modify airline ticket tax deposit rule to suspend deposits due 8/15/97 to 9/30/97 until 10/10/97, and suspend deposits due 8/15/98 to 9/30/98 until 10/5/98	DOE	−1,017	−199	1,216									
c. Reduce air passenger ticket tax to 7.5% of ticket price (and omit segment tax) for flight segment to/from certain rural airports [17]	10/1/97	.....	−26	−27	−26	−27	−27	−28	−30	−31	−32	−33	−289

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
d. Extend international departure tax: increase tax from $6.00 to $12/passenger, tax arrivals at the same rate, and index the $12 tax to changes in the CPI (first indexing adjustment on 1/1/99), but retain present-law $6.00/passenger departure tax for domestic flights to/from Alaska and Hawaii, and index the $6.00 departure tax to changes in the CPI (first indexing adjustment on 1/1/99)	10/1/97	.....	788	879	948	1,026	1,114	1,209	1,307	1,411	1,526	1,653	11,859
e. Impose 7.5% tax rate on cash payments to airlines for air travel under credit card and similar programs	10/1/97	.....	65	73	77	82	87	92	98	104	110	116	904
f. Extend current air cargo excise tax	10/1/97	.....	304	347	377	409	443	481	522	567	615	667	4,732
g. Extend current taxes on noncommercial aviation gasoline and noncommercial jet fuel	10/1/97	.....	84	87	89	91	93	95	97	99	102	104	943
h. Dedicate 4.3 cents/gallon of tax on aviation fuel to the Airport and Airway Trust Fund	10/1/97	.....	.....	.....	.....	No Revenue Effect				.....	.....	.....	.....
2. Extend diesel fuel excise tax rules to kerosene	7/1/98	.....	44	43	49	46	44	43	44	47	49	52	461
3. Reinstate LUST excise tax and extend through 3/31/05	10/1/97	.....	129	129	128	129	131	134	136	67	.....	.....	983
4. Apply 3% telephone excise tax to certain prepaid phone cards and cash payments to service providers under credit card arrangements	11/1/97	.....	19	28	38	49	60	71	83	101	113	124	684

5. Extend FUTA surtax and increase the statutory limit on the FUA Trust Fund from .25% of covered wages to .50% [16]	lpo/a 1/1/99		1,063	1,763	1,797	1,733	661	−73	−71	−74	−73	6,726
E. Provisions Relating to Tax-Exempt Organizations													
1. Modify control test and include attribution rules to determine UBIT consequences of certain payments from subsidiaries of tax-exempt organizations	tyba 12/31/98 & tyba 2ya DOE		[8]	[8]	[8]	3	5	5	4	4	4	4	29
2. Repeal grandfather rule with respect to pension business of certain insurers	tyba 12/31/97		[8]	82	116	124	128	133	140	149	160	174	1,208
F. Foreign Provisions													
1. Inclusion of income from notional principal contracts and stock lending transactions under Subpart F	tyba DOE		9	20	21	21	21	21	22	22	22	23	202
2. Restrict like-kind exchanges involving foreign personal property	ea 6/8/97		4	8	11	13	15	17	19	21	23	25	156
3. Impose holding period requirement for claiming foreign tax credits with respect to dividends	dpoaa 30da DOE		23	48	50	53	56	58	61	64	68	71	552
4. Limitation on treaty benefits for payments to hybrid entities	DOE		1	1	1	1	1	1	1	1	1	1	10
5. Interest on underpayment reduced by foreign tax credit carrybacks	ftpoa tyba DOE		8	10	2	1	1	1	1	1	1	1	27

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
6. Determination of period of limitations relating to foreign tax credits	ftpoa tyba DOE	.....	1	2	1	1	1	1	1	1	1	1	11
7. Repeal special exception which permits certain companies to eliminate their AMT liability	tyba DOE	.....	2	5	5	5	5	5	5	5	5	5	47
G. Partnership Provisions													
1. Allocation of basis of properties distributed to a partner by a partnership	pda DOE	.....	26	52	55	57	59	61	64	66	69	72	581
2. Eliminate the substantial appreciation requirement for inventory on sale of partnership interest	sepda DOE & efbcieo 6/8/97	.....	30	66	69	73	77	80	84	89	93	98	760
3. Extension of time for taxing precontribution gain	pcpa 6/8/97	.....					2	10	11	11	12	12	58
H. Pension and Employee Benefit Provisions													
1. Increase involuntary cash out amount from $3,500 to $5,000 (no indexing of dollar amount)	pyba DOE	(8)	2	6	7	7	7	8	8	9	9	10	73
2. Election to receive taxable cash compensation in lieu of nontaxable parking benefits (18)	tyba 12/31/97	.....	3	8	11	12	12	13	14	14	15	16	118

3. Repeal of 15% excess distribution and excess retirement accumulation taxes	dra & dda 12/31/96	−18	−19	−7	18	18	16	16	14	13	11	62
4. Increase in prohibited transactions excise tax	ptoa DOE	2	4	4	4	4	4	4	4	4	4	34
5. Modify basis recovery rules	aba 12/31/97	1	3	6	9	11	15	18	21	24	27	133
I. Other Revenue-Increase Provisions												
1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting [19]	[20]	29	33	35	36	37	39	40	41	43	44	377
2. 2-year carryback and 20-year carryforward for net operating losses with an exception related to Presidentially declared disaster areas	NOLgi tyba DOE	42	303	361	256	179	136	112	100	93	90	1,672
3. Limit carryback period for general business credits to 1 year; extend carryforward period to 20 years	cai tyba 12/31/97	182	300	81	−60	−32	−9	5	15	21	25	527
4. Modification of treatment of company-owned life insurance—disallowance of certain interests and premiums; pro rata disallowance of interest on debt to fund life insurance	cia 6/8/97	20	53	93	140	193	247	299	349	399	447	2,240
5. Earned income Credit ("EIC") compliance provisions:												
a. Deny EIC eligibility for prior acts of recklessness or fraud; recertification required when EIC denied in past; and due diligence requirement for paid preparers	tyba 12/31/96	[8]	18	25	24	21	21	21	21	21	21	193

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
b. For the purpose of EIC phase-out, include in AGI nontaxable distributions of IRA, pensions, and annuities, and tax-exempt interest; and addback 75% of business losses (21)	tyba 12/31/97	.....	(8)	72	75	79	85	89	92	94	99	102	788
6. Provide that workfare payments do not qualify as earned income for the purposes of the earned income credit	DOE	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....
7. Restrict income forecast method and allow 3-year MACRS for rent-to-own property; with clarification for home computers and cellular phones	ppisa DOE	.....	29	41	62	78	38	27	25	17	17	18	352
8. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person	icoa 6/8/97	.....	1	4	6	8	11	13	15	17	19	21	115
9. Repeal of exception for certain sales by manufacturers to dealers	tyb1ya DOE	.....	.....	44	97	106	106	64	21	22	23	24	507
10. Limitation on charitable remainder trust annual payouts; require charitable remainders to have a minimum value of 10% of trust	Ta 6/18/97	.....	6	6	6	6	6	6	6	6	6	6	60
11. Expanded SSA records for tax enforcement (22)	180da DOE	.....	.....	10	10	10	10	10	10	10	10	10	90

12. Using Federal case registry of child support orders for tax enforcement purposes (22)	10/1/98				10	20	30	40	60	85	105	350
13. Prior year estimated tax safe harbor (100% in 1998, 105% in 1999 through 2001, and 112% in 2002)	DOE	−7,400	4,000			4,400	−1,000					
Title XI. Foreign Tax Provisions												
A. General Provisions												
1. Simplify foreign tax credit limitation for individuals	tyba 12/31/97	(23)	−1	−1	−1	−1	−1	−1	−1	−1	−1	−9
2. Simplify translation of foreign taxes	ftpo tyba 12/31/97	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)
3. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes	tyba 12/31/97	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	−2
4. Simplify treatment of personal transactions in foreign currency	tyba 12/31/97	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	−2
5. Simplify foreign tax credit limitation for dividends from 10/50 companies to provide look-through starting in 2003	tyba 12/31/02						−57	−241	−215	−227	−242	−982
B. General Provisions Affecting Treatment of Controlled Foreign Corporations	various (5)	−2	−5	−7	−9	−10	−10	−11	−12	−13	−14	−93
C. Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap With Subpart F, to Allow Mark-to-Market Election, and to Require Measurement Based on Value for PFIC Asset Test	tyba 12/31/97	−24	−23	−24	−26	−27	−28	−29	−31	−33	−35	−280
D. Simplify Formation and Operation of International Joint Ventures	various (5)	(7)	(7)	−1	−1	−1	−1	−1	−1	−1	−2	−9

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
E. Modification of Reporting Threshold for Stock Ownership of a Foreign Corporation	toa 12/31/97	.....	(23)	−1	−2	−2	−2	−2	−2	−3	−3	−3	−20
F. Other Foreign Simplification Provisions													
1. Transition rule for certain trusts	tyba 12/31/96	.....	−1	−3	−5	−5	−5	−5	−5	−5	−5	−5	−44
2. Simplify application of the stock and securities trading safe harbor	tyba 12/31/97	.....	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)
3. Clarification of determination of foreign taxes deemed paid	DOE	.....	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)
4. Clarification of foreign tax credit limitation for financial services income	DOE	.....	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)
G. Other Foreign Provisions													
1. Eligibility of licenses of computer software for foreign sales corporation benefits	gra 12/31/97	.....	−27	−42	−146	−173	−180	−191	−202	−227	−252	−277	−1,717
2. Increase dollar limitation on section 911 exclusion and index after 2007	tyba 12/31/97	.....	−15	−30	−50	−67	−82	−97	−103	−111	−119	−127	−801
3. Exception from U.S. property definition under subpart F for certain securities positions	tyba 12/31/97	.....	−1	−2	−2	−2	−2	−2	−2	−2	−2	−2	−19

4. Treat service income of nonresident alien individuals earned on foreign ships as foreign source income and disregard the U.S. presence of such individuals	tyba 12/31/97	.....	−2	−4	−3	−3	−3	−3	−3	−3	−3	−3	−30
5. Exemption from subpart F for active financing income (14)	tybi 1998	.....	−23	−68	−3	.....	.....	.....	.....	.....	.....	.....	−94
Title XII. Simplification Provisions Relating to Individuals and Businesses													
A. Provisions Relating to Individuals													
1. Deduction attributable to unearned income of dependent filers: greater of (a) present law; or (b) earned income plus $250; delink dependent AMT from parent's AMT position	tyba 12/31/97	.....	−2	−38	−35	−35	−35	−35	−35	−38	−37	−36	−327
2. Increase de minimis threshold for estimated tax to $1,000 for individuals	tyba 12/31/97	.....	−134	−17	−18	−19	−20	−21	−22	−24	−25	−26	−326
3. Treatment of certain reimbursed expenses for rural mail carriers' vehicles	tyba 12/31/97	.....	(7)	−1	−1	−1	−1	−1	−1	−1	−1	−1	−11
4. Treatment of travel expenses of certain Federal employees participating in a Federal criminal investigation	apoii tyea DOE	.....	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	−2
5. Permit payment of taxes by any commercially acceptable means; and prohibit payment of fees by Treasury	9ma DOE	.....	.....	.....	.....	Negligible Revenue Effect	.....	.....	.....	.....	.....	.....	.....
B. Provisions Relating to Businesses Generally													
1. Modifications to look-back method for long-term contracts	cci tyea DOE	.....	−1	−2	−3	−4	−4	−4	−4	−5	−5	−5	−37

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
2. Minimum tax treatment of certain property and casualty insurance companies	tyba 12/31/97		−1	−2	−3	−3	−3	−3	−3	−3	−3	−3	−27
3. Treatment of construction allowances provided to lessees	leia DOE	Negligible Revenue Effect											
C. Partnership Simplification Provisions													
1. General provisions:													
a. Simplified reporting to partners	tyba 12/31/97		6	8	8	8	8	9	9	9	9	9	83
b. Simplified audit procedure for large partnerships	tyba 12/31/97		(8)	(8)	(8)	1	1	1	1	1	1	1	8
c. Due date for furnishing information to partners of large partnerships	tyba 12/31/97	No Revenue Effect											
d. Returns required on magnetic media for partnerships with 100 partners or more	tyba 12/31/97	Negligible Revenue Effect											
e. Treatment for partnership items of individual retirement arrangements	tyba 12/31/97	No Revenue Effect											
2. Other partnership audit rules	various (5)		−2	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	−5
3. Closing partnership taxable year with respect to deceased partner	tyba 12/31/97		(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	−1

D. Modifications of Rules for Real Estate Investment Trusts													
1. Alternative penalty for failure to request information from shareholders	tyba DOE	Negligible Revenue Effect											
2. De minimis rule for tenant services income	tyba DOE	Negligible Revenue Effect											
3. Attribution rules applicable to tenant ownership	tyba DOE	Negligible Revenue Effect											
4. Credit for tax paid by REIT on retained capital gains	tyba DOE	Negligible Revenue Effect											
5. Repeal 30% gross income requirment	tyba DOE		−4	−5	−5	−6	−7	−7	−8	−9	−10	−11	−72
6. Modification of earnings and profits rules for determining whether REIT has earnings and profits from non-REIT year	tyba DOE	Negligible Revenue Effect											
7. Treatment of foreclosure property	tyba DOE	Negligible Revenue Effect											
8. Payments under hedging instruments	tyba DOE	Negligible Revenue Effect											
9. Excess noncash income	tyba DOE	Negligible Revenue Effect											
10. Prohibited transaction safe harbor	tyba DOE	Negligible Revenue Effect											
11. Shared appreciation mortgages	tyba DOE	Negligible Revenue Effect											
12. Wholly owned subsidiaries	tyba DOE	Negligible Revenue Effect											
E. Repeal 30% Gross Income Limitation for Regulated Investment Companies	tyba DOE		−17	−23	−27	−33	−38	−45	−53	−61	−71	−82	−450

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
F. Taxpayer Protections													
1. Provide reasonable cause exception for additional penalties	tyba DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...
2. Clarification of period for filing claims for refunds	tyea DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...
3. Repeal authority to disclose whether a prospective juror has been audited	pca DOE	...	...	...	...	No Revenue Effect				...	...	...	...
4. Clarify statute of limitations for items from pass-through entities	tyba DOE	...	...	...	...	No Revenue Effect				...	...	...	...
5. Awarding of administrative costs and attorneys fees	aca DOE	...	...	...	...	No Revenue Effect				...	...	...	...
Title XIII. Estate, Gift, and Trust Simplification Provisions													
1. Eliminate gift tax filing requirements for gifts to charities of over $10,000	gma DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...
2. Clarification of waiver of certain rights of recovery of estate tax from QTIP trust	dda DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...
3. Transitional rule under section 2056A	aiii OBRA'90	...	...	...	...	Negligible Revenue Effect				...	...	...	...
4. Estate and gift tax treatment of short-term OID instruments	dda DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...

5. Certain revocable trusts treated as part of estate	dda DOE		−3	−3	−3	−3	−3	−3	−3	−3	−3	−3	−30
6. Distributions during first 65 days of taxable year of estate	tyba DOE	Negligible Revenue Effect											
7. Separate share rules available to estates	dda DOE	Negligible Revenue Effect											
8. Executor of estate and beneficiaries treated as related persons for disallowance of losses	tyba DOE	Negligible Revenue Effect											
9. Simplified taxation of earnings of pre-need funeral trusts	tyea DOE		2	2	2	2	2	2	2	2	2	2	20
10. Adjustments for certain gifts within 3 years of decedent's death	dda DOE	No Revenue Effect											
11. Clarification of treatment of survivor annuities under qualified terminable interest rules	dda DOE	Negligible Revenue Effect											
12. Treatment under qualified domestic trust rules of forms of ownership which are not trusts	dda DOE	Negligible Revenue Effect											
13. Opportunity to correct certain failures under section 2032A	DOE	Negligible Revenue Effect											
14. Authority to waive requirement of United States trustee for qualified domestic trusts	dda DOE	No Revenue Effect											
Title XIV. Excise Tax and Other Simplification Provisions													
A. Excise Tax Simplification Provisions													
1. Increase de minimis limit for after-market alterations for heavy truck and luxury automobile excise taxes	ia DOE	Negligible Revenue Effect											

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
2. Replace truck excise tax deduction for tire value with tax credit for excise tax paid on tires	Sa 12/31/97	.....	66	94	96	97	99	101	102	105	108	110	979
3. Simplification of excise taxes on distilled spirits, wine, and beer:													
a. Credit or refund for imported bottled distilled spirits returned to distilled spirits plant	fcq DOE + 180 days	.....				Negligible Revenue Effect				.....			
b. Authority to cancel or credit export bonds without submission of records	fcq DOE + 180 days	.....				No Revenue Effect				.....			
c. Repeal of required maintenance of records on premises of distilled spirits plant	fcq DOE + 180 days	.....				No Revenue Effect				.....			
d. Fermented material from any brewery may be received at a distilled spirits plant	fcq DOE + 180 days	.....				Negligible Revenue Effect				.....			
e. Repeal of requirement for wholesale dealers in liquors to post sign	DOE	.....				No Revenue Effect				.....			
f. Refund of tax to wine returned to bond not limited to unmerchantable wine	fcq DOE + 180 days	.....				Negligible Revenue Effect				.....			

g. Use of additional ameliorating material in certain wines	fcq DOE + 180 days	...				No Revenue Effect							...
h. Domestically produced beer may be withdrawn free of tax for use of foreign embassies, legations, etc	fcq DOE + 180 days	...				Negligible Revenue Effect							...
i. Beer may be withdrawn free of tax for destruction	fcq DOE + 180 days	...				Negligible Revenue Effect							...
j. Authority to allow drawback on exported beer without submission of records	fcq DOE + 180 days	...				No Revenue Effect							...
k. Imported beer or wine transferred in bulk to brewery or winery without payment of tax	fcq DOE + 180 days	...				Negligible Revenue Effect							...
4. Authority for IRS to grant exemption from excise tax registration requirements	wia DOE	...				No Revenue Effect							...
5. Repeal of excise tax "deadwood" provisions	DOE	...				No Revenue Effect							...
6. Move taxation of arrows from tax on assembled arrows to tax on component parts of 12.4%	Csa 9/30/97	...				Negligible Revenue Effect							...
7. Modifications to heavy highway vehicle retail excise tax:													
a. Exemption from truck excise tax for certain wrecked truck fixups and truck modifications	1/1/98	...	−5	−8	−8	−8	−9	−9	−10	−10	−11	−11	−89
b. Repeal registration requirement for tax-free sales of trucks for resale	1/1/98	...				Negligible Revenue Effect							...
8. Treatment of skydiving flights as noncommerical aviation	10/1/97	...				Negligible Revenue Effect							...

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
9. Eliminate double taxation for certain purchases of aviation fuel from "fixed-based operators"	10/1/97	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....
B. Tax-Exempt Bond Provisions													
1. Repeal $100,000 limitation on unspent proceeds from tax-exempt bond issues under year exception from rebate	bia DOE	.....	(7)	−2	−3	−5	−6	−8	−9	−10	−11	−12	−65
2. Exclusion from arbitrage rebate for earnings on bona fide debt service fund under construction bond rules	bia DOE	.....	(7)	−1	−2	−3	−3	−4	−5	−6	−6	−7	−37
3. Repeal of debt service-based limitation on investment in certain nonpurpose investments	bia DOE	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....
4. Repeal of expired student loan bond arbitrage rebate provisions	bia DOE	.....	.....	.....	.....	No Revenue Effect				.....	.....	.....	.....
C. Tax Court Procedures													
1. Overpayment determinations of Tax Court	DOE	.....	−3	−3	−3	−3	−3	−3	−3	−3	−3	−3	−30
2. Redetermination of interest pursuant to motion	DOE	.....	.....	.....	.....	No Revenue Effect				.....	.....	.....	.....
3. Application of net worth requirements for awards of administrative or litigation costs; $4 million for joint returns	pca DOE	.....	−1	−2	−2	−2	−2	−2	−2	−2	−2	−2	−19
4. Tax Court jurisdiction for determination of employment status	DOE	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....

D. Other Provisions													
1. Due date for first quarter estimated tax by private foundations	tyba DOE	−2	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	−3
2. Withholding of Commonwealth income taxes from wages of Federal employees	1/1/98	−2	−3	−1	−1	−1	−1	−1	−1	−1	−1	−13
3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments	Pa 12/31/97	−1	−1	−1	−1	−1	−1	−1	−1	−1	−1	−10
Title XV. Pension and Employee Benefit Provisions													
A. Pension Simplification Provisions													
1. Matching contributions for self-employed individuals not treated as elective deferrals	yba 12/31/97	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(24)
2. Modification of prohibition on assignment or alienation	DOE	Negligible Revenue Effect										
3. Eliminate paperwork burdens on plans	DOE	No Revenue Effect										
4. Modifications to section 403(b) exclusion allowance to conform to section 415 modifications	yba 12/31/97		(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(24)
5. Permanent moratorium on nondiscrimination rules to State and local governmental plans	tybo/a DOE	Negligible Revenue Effect										
6. Clarification of certain rules relating to employee stock ownership plans of S corporation	tyba 12/31/97	Negligible Revenue Effect										
7. Modification of 10% tax on nondeductible contributions	tyba 12/31/97	−2	−3	−3	−3	−3	−3	−3	−3	−3	−3	−29
8. Modify funding requirements for certain plans	pyba 12/31/96	Negligible Revenue Effect										
9. Plans not disqualified merely by accepting rollover contributions	DOE	Negligible Revenue Effect										

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
10. New technologies in retirement plans	DOE	...				No Revenue Effect				...			
B. Miscellaneous Provisions Relating to Pensions and Other Benefits													
1. Increase in full funding limit with 20-year amortization	pyba 12/31/98	...		−4	−12	−14	−18	−19	−23	−23	−25	−25	−164
2. Deduction for contributions made by ministers to retirement plans	yba 12/31/97	...				Negligible Revenue Effect				...			
3. Exclusion of ministers from discrimination testing of certain non-church retirement plans	yba 12/31/97	...				Negligible Revenue Effect				...			
4. Repeal UBIT on income from an S corporation to an ESOP	tyba 12/31/97	...	−8	−23	−34	−41	−44	−46	−48	−50	−52	−54	−400
5. Diversification of section 401(k) plan investments	1/1/99	...				Negligible Revenue Effect				...			
6. Water districts made eligible for 401(k) plans even if State or local entity	yba 12/31/97	...	(23)	−1	−1	−1	−2	−2	−2	−2	−2	−3	−15
7. Modify section 415 limits for permissive service credits under State and local plans	yba 12/31/97	...	−9	−25	−25	−26	−26	−26	−27	−27	−27	−28	−246
8. Removal of dollar limitation on benefits payments from a defined benefit plan for police and fire employees	yba 12/31/96	...				Negligible Revenue Effect				...			

9. Exclude from gross income certain survivor benefits attributable to a public safety officer who is killed in the line of duty	(25)	.....	(7)	−1	−1	−1	−1	−1	−1	−1	−2	−2	−12
10. Treatment of certain disability benefits to public safety employees	DOE	.....	−10	−1	.....	.....	.....	.....	.....	.....	.....	.....	−11
11. Gratuitous transfers for the benefit of employees	Ta DOE	.....	−8	−15	.....	.....	.....	.....	.....	.....	.....	.....	−23
C. Certain Health Act Provisions													
1. Excise tax penalties for failure of group health plan to provide certain maternity and mental health benefits	pybo/a 1/1/98	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....
2. Church plan exception to prohibition on discrimination against individuals based on health status	aiii HIPAA	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....
D. Date for Adoption of Plan Amendments	DOE	.....	.....	.....	.....	No Revenue Effect				.....	.....	.....	.....
Title XVI. Technical Corrections Provisions													
1. Oklahoma technical on Indian wage credits and development incentives for property with 10-year lives or less	dwcorfpt 3/18/97	.....	−10	−2	1	2	2	1	1	1	1	1	−2
2. Luxury tax clarification	Sa DOE	.....	.....	.....	.....	No Revenue Effect				.....	.....	.....	.....
Subtotal: H.R. 2014		**60**	**−9,483**	**−9,887**	**−27,937**	**−29,329**	**−23,865**	**−34,966**	**−36,611**	**−38,652**	**−39,809**	**−41,551**	**−292,045**
PART THREE: REVENUE PROVISIONS OF THE BALANCED BUDGET ACT OF 1997 (H.R. 2015)													
A. Treatment of Medicare+Choice Medical Savings Accounts	tyba 12/31/98	.....	.....	.....	.....	Negligible Revenue Effect				.....	.....	.....	.....

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN 1997

Fiscal Years 1997–2007

[Millions of dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–07
B. Tax Treatment of Hospitals Which Participate in Provider-Sponsored Organizations	DOE	...	...	...	...	Negligible Revenue Effect				...	...	...	...
C. Provision of Employer Identification Numbers by Medicare Providers	(26)	...	...	...	...	Negligible Revenue Effect				...	...	...	...
D. Disclosure of Tax Return Information for Verification of Employment Status of Medicare Beneficiaries and Spouses of Medicare Beneficiaries (27)	DOE	...	...	...	...	No Revenue Effect				...	...	...	...
E. Unemployment Tax Provisions—Miscellaneous FUTA provisions (16)	various (5)	...	3	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	(7)	...
F. Earned Income Tax Credit Provision—Authorization of appropriations for enforcement initiatives related to the earned income credit (22)	DOE	...	...	...	...	No Revenue Effect				...	...	...	...
G. Increase in Excise Tax on Tobacco Products—Increase small cigarettes tax by $0.10 per pack in 2000 and 2001, and $0.15 per pack in 2002 and thereafter with proportionate increase in other tobacco products excise taxes; extend tax to "roll-your-own" tobacco	1/1/00	...	...	...	1,175	1,720	2,272	2,280	2,290	2,300	2,310	2,320	16,667
Subtotal: H.R. 2015		...	**3**	**(7)**	**1,175**	**1,720**	**2,272**	**2,280**	**2,290**	**2,300**	**2,310**	**2,320**	**16,667**

PART FOUR: TAXPAYER BROWSING PROTECTION ACT (H.R. 1226)													
1. Civil damages for unauthorized inspection of tax returns or tax return information; notification of unlawful inspection or disclosure ..	voo/a DOE	(28)	(28)	(28)	(28)	(28)	(28)	(28)	(28)	(28)	(28)	(28)	(28)
Subtotal: H.R. 1226		**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**	**(28)**
PART FIVE: HIGHWAY TRUST FUND EXTENSION (S. 1519)													
1. Extend Highway Trust Fund expenditure and revenue transfer authority through 9/30/98; extend Boat Safety Account and National Recreational Trails Trust Fund expenditure authority through 9/30/98	10/1/97	.....				No Revenue Effect			.....				
Subtotal: S. 1519		.....				**No Revenue Effect**			.....				

Joint Committee on Taxation.

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aba=annuities beginning after
aca=actions commenced after
aiii HIPAA=as if included in the Health Insurance Portability and Accountability Act
aiii OBRA'90=as if included in the Omnibus Budget Reconciliation Act of 1990
aoty=all open taxable years
apoii=amounts paid or incurred in
bia=bonds issued after
cai=credits arising in
cci=contracts completed in
cfa=claims filed after
cia=contracts issued after
csa=constructive sales after
Csa=components sold after
da=distributions after
dda=decedents dying after
di=dispositions in
Dmi=distributions made in
doaa=distributions or acquisitions after
DOE=date of enactment
Doia=discharges of indebtedness after
dpoaa=dividends paid or accrued after
dra=distributions received after
droaa=dividends received or accrued after
dwcorfpt=depreciation and wages claimed on returns filed prior to
ea=exchanges after
efbcieo=exception for binding contracts in effect on
epoia=expenses paid or incurred after
fcq DOE + 180 days=first day of the calendar quarter that begins at least 180 days after date of enactment
fsa=fuels sold after
fsoua=fuels sold or used after
ftpoa=foreign taxes paid or accrued in
gma=gifts made after
gra=gross receipts after
gsta=generation skipping transfers after
ia=installations after
icoa=involuntary conversions occurring after
iia=instruments issued after
leia=leases entered into after
lia=levies issued after
lpo/a=labor performed on or after
NOLgi=net operating losses generated in
pa=payments after
Pa=periods after
pca=proceedings commenced after
pcpa=property contributed to partnership after
pda=partnership distributions after
pma=payments made after
po/a=purchases on or after
poida=payments of interest due after
ppisa=property placed in service after
psora=payments solicited or received after
ptoa=prohibited transactions occurring after
pyba=plans years beginning after
pybo/a=plans years beginning on or after
qza=qualified zone academy
rd=returns due
rfa=returns filed after
roa=rentals occurring after (for returns open on date of first committee action)
Sa=sales after
saia=sales and installations after
sea=sales or exchanges after
sepda=sales and exchanges, and certain partnership distributions after
spa=services performed after
ta=transactions after
Ta=transfers after
toa=transactions occurring after
tp7data=tickets purchased 7 days after date of enactment for travel 7 days after
tsoaiTg=tax shelters offered after issuance of Treasury guidance
tyba=taxable years beginning after
tyb1ya=taxable years beginning 1 year after
tybo/a=taxable years beginning on or after
tybi=taxable years beginning in
tyea=taxable years ending after
voo/a=violations occurring on or after
wia=waivers issued after
wpoifhma=wages paid or incurred for hires made after
yba=years beginning after
30da=30 days after
90da=90 days after
180da=180 days after
9ma=9 months after
2ya=2 years after

Footnotes for Appendix:

[1] Estimate considers interaction with HOPE tax credit proposal.
[2] The estimate includes a refundable portion of the child credit equal to $4,281 million for fiscal years 1998–2002 and $10,022 million for fiscal years 1998–2007.
[3] Estimate includes interaction with estate and gift taxes.
[4] Considers interaction with IRA PLUS proposal.
[5] For complete breakout of the effective date, refer to the body of the text.
[6] Estimate includes interaction with Welfare-to-Work tax credit.
[7] Loss of less than $500,000.
[8] Gain of less than $500,000.
[9] Effective for bonds issued after 12/31/96 and bonds issued before 1/1/99.
[10] Effective for taxable years beginning after 12/31/97 and before 1/1/01.
[11] Effective for expenses in taxable years ending after date of enactment and before 1/1/01.
[12] Estimate includes interaction with Brownfields provision.
[13] Assumes prior or concurrent passage of legislation to allow Virgin Island financing on parity basis.
[14] Provision was cancelled by the President pursuant to the Line Item Veto Act of 1996.
[15] The provision became effective on 12/2/97, upon enactment of the Amtrak Reform and Accountability Act of 1997.
[16] Estimate provided by the Congressional Budget Office.
[17] Rural airports are defined as (1) airports receiving "essential air service" assistance on date of enactment and having fewer than 100,000 enplanements in the previous calendar year, and (2) other airports having fewer than 100,000 passenger enplanements in the previous calendar year, excluding those within 75 miles of airports having more than 100,000 passenger enplanements in the previous year.
[18] Estimate does not include increase in receipts to Social Security trust fund ($21 million for fiscal years 1997–2002; $51 million for fiscal years 1997–2007).
[19] The provision also eliminates the present-law requirement that a portion of the suspense account be restored to income whenever the gross receipts of the corporation decline.
[20] Provision is effective for taxable years ending after 6/8/97 for new suspense accounts, and taxable years beginning after that date for existing accounts. Balances in new accounts are included in income over a 10-year period, and balances in existing accounts over a 20-year period. For existing accounts, the amounts included in income in any year may not exceed 50% of the taxable income of the taxpayer before the inclusion.
[21] Estimate includes outlay reductions of $254 million for 1997–2002 and $650 million for 1997–2007.
[22] Estimate does not include effect on outlays. Outlays will be provided by the Congressional Budget Office.
[23] Loss of less than $1 million.
[24] Loss of less than $10 million.
[25] Effective for payments received in taxable years beginning after 12/31/96 with respect to individuals dying after such date.
[26] Effective 90 days after the Secretary of HHS submits to the Congress a report on the steps taken to ensure the confidentiality of social security account numbers required to be provided to the Secretary of HHS.
[27] Revenue estimate does not include outlay effects of the provision.
[28] Gain of less than $1 million.

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