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105TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

REPORT
105–148

REVENUE RECONCILIATION ACT OF 1997

REPORT

OF THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

TO ACCOMPANY

H.R. 2014

A BILL TO PROVIDE FOR RECONCILIATION PURSUANT TO SUBSECTIONS (b)(2) AND (d) OF SECTION 105 OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1998

together with

ADDITIONAL AND DISSENTING VIEWS

JUNE 24, 1997.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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105TH CONGRESS 1st Session } HOUSE OF REPRESENTATIVES { REPORT 105–148

PROVIDING FOR RECONCILIATION PURSUANT TO SUBSECTIONS (b)(2) AND (d) OF SECTION 105 OF THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1998

JUNE 24, 1997.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. KASICH, from the Committee on the Budget, submitted the following

REPORT

together with

ADDITIONAL AND DISSENTING VIEWS

[To accompany H.R. 2014]

[Including cost estimate of the Congressional Budget Office]

The Committee on the Budget, to whom reconciliation recommendations were submitted pursuant to subsections (b)(2) and (d) of section 105 of House Concurrent Resolution 84, the concurrent resolution on the budget for fiscal year 1998, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

A BILL To provide for reconciliation pursuant to subsections (b)(2) and (d) of section 105 of the concurrent resolution on the budget for fiscal year 1998.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE.

(a) SHORT TITLE.—This Act may be cited as the “Revenue Reconciliation Act of 1997”.

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title; amendment of 1986 Code.

TITLE I—CHILD TAX CREDIT; TAX INCENTIVES FOR DEPENDENT CARE AND HEALTH CARE FOR CHILDREN

Sec. 101. Child tax credit.
Sec. 102. Inflation adjustment of limits and other modifications of dependent care credit.

TITLE II—EDUCATION INCENTIVES

Subtitle A—Tax Benefits Relating to Education Expenses

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TITLE VI—EXTENSION AND MODIFICATION OF CERTAIN EXPIRING PROVISIONS

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Sec. 602. Contributions of stock to private foundations.
Sec. 603. Work opportunity tax credit.
Sec. 604. Orphan drug tax credit.

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Sec. 702. Incentives conditioned on other DC reform.

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Sec. 801. Incentives for employing long-term family assistance recipients.

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TITLE I—CHILD TAX CREDIT; MODIFICATION OF DEPENDENT CARE CREDIT

SEC. 101. CHILD TAX CREDIT.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to nonrefundable personal credits) is amended by inserting after section 23 the following new section:

"SEC. 24. CHILD TAX CREDIT.

"(a) ALLOWANCE OF CREDIT.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to $500 multiplied by the number of qualifying children of the taxpayer.

"(b) LIMITATIONS.—

"(1) LIMITATION BASED ON ADJUSTED GROSS INCOME.—For limitation based on adjusted gross income, see section 26(c).

"(2) REDUCTION FOR DEPENDENT CARE CREDIT.—In the case of taxable years beginning after December 31, 2001—

"(A) IN GENERAL.—The credit allowed by subsection (a) for the taxable year (determined after paragraph (1) but before paragraph (3)) shall be reduced by the amount equal to 50 percent of the credit allowed under section 21 for such taxable year (determined after section 26(c)).

"(B) NO REDUCTION FOR DEPENDENT CARE OF INDIVIDUALS INCAPABLE OF SELF-CARE.—Subparagraph (A) shall not apply to so much of the credit which would have been allowed under section 21 (determined without regard to section 26(c)) if only qualifying individuals described in subparagraph (B) or (C) of section 21(b)(1) were taken into account.

"(3) LIMITATION BASED ON AMOUNT OF TAX.—The credit allowed by subsection (a) (determined after paragraphs (1) and (2)) shall not exceed the excess (if any) of—

"(A) the taxpayer's regular tax liability for the taxable year reduced by the credits allowable against such tax under this subpart (other than this section), over

"(B) the sum of—

"(i) the taxpayer's tentative minimum tax for such taxable year (determined without regard to the alternative minimum tax foreign tax credit), plus

"(ii) the credit allowed for the taxable year under section 32.

"(c) QUALIFYING CHILD.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualifying child' means any individual if—

"(A) the taxpayer is allowed a deduction under section 151 with respect to such individual for the taxable year,

"(B) such individual 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

"(C) such individual bears a relationship to the taxpayer described in section 32(c)(3)(B).

"(2) EXCEPTION FOR CERTAIN NONCITIZENS.—The term 'qualifying child' shall not include any individual who would not be a dependent if the first sentence of section 152(b)(3) were applied without regard to all that follows 'resident of the United States'.

"(d) TAXABLE YEAR MUST BE FULL TAXABLE YEAR.—Except in the case of a taxable year closed by reason of the death of the taxpayer, no credit shall be allowable under this section in the case of a taxable year covering a period of less than 12 months.

"(e) PHASEIN OF CREDIT.—In the case of taxable years beginning in 1998, subsection (a) shall be applied by substituting '$400' for '$500'."

(b) HIGH RISK POOLS PERMITTED TO COVER DEPENDENTS OF HIGH RISK INDIVIDUALS.—Paragraph (26) of section 501(c) is amended by adding at the end the following flush sentence:

"A qualifying child (as defined in section 24(c)) of an individual described in subparagraph (B) (without regard to this sentence) shall be treated as described in subparagraph (B)."

(c) CONFORMING AMENDMENTS.—

(1) Subsection (a) of section 26 is amended by inserting "(other than the credit allowed by section 24)" after "credits allowed by this subpart".

(2) The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by inserting after the item relating to section 23 the following new item:

"Sec. 24. Child tax credit."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 102. INFLATION ADJUSTMENT OF LIMITS AND OTHER MODIFICATIONS OF DEPENDENT CARE CREDIT.

(a) INFLATION ADJUSTMENT.—

(1) IN GENERAL.—Subsection (c) of section 21 (relating to expenses for household and dependent care services necessary for gainful employment) is amended to read as follows:

"(c) DOLLAR LIMIT ON AMOUNT CREDITABLE.—

"(1) IN GENERAL.—The amount of the employment-related expenses incurred during any taxable year which may be taken into account under subsection (a) shall not exceed—

"(A) $2,400 if there is 1 qualifying individual with respect to the taxpayer for such taxable year, or

"(B) $4,800 if there are 2 or more qualifying individuals with respect to the taxpayer for such taxable year.

The amount determined under subparagraph (A) or (B) (whichever is applicable) shall be reduced by the aggregate amount excludable from gross income under section 129 for the taxable year.

"(2) INFLATION ADJUSTMENT.—In the case of taxable years beginning in a calendar year after 1997, each of the dollar amounts contained in paragraph (1) shall be increased by an amount equal to—

"(A) such dollar amount, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1996' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $50, such amount shall be rounded to the next lowest multiple of $50."

(2) CONFORMING AMENDMENT.—Paragraph (2) of section 21(d) is amended by striking "(c)(1)" and inserting "(c)(1)(A)" and by striking "(c)(2)" and inserting "(c)(1)(B)".

(b) REDUCTION OF BENEFIT BASED ON ADJUSTED GROSS INCOME.—

(1) IN GENERAL.—Section 26 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) REDUCTION OF DEPENDENT CARE CREDIT AND CHILD CREDIT BASED ON ADJUSTED GROSS INCOME.—

"(1) IN GENERAL.—The aggregate amount which would (but for subsection (a), this subsection, and paragraphs (2) and (3) of section 24(b)) be allowed under sections 21 and 24 shall be reduced (but not below zero) by $25 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income exceeds the threshold amount. For purposes of the preceding sentence, the term 'modified adjusted gross income' means adjusted gross income increased by any amount excluded from gross income under section 911, 931, or 933.

"(2) THRESHOLD AMOUNT.—For purposes of paragraph (1), the term 'threshold amount' means—

"(A) $110,000 in the case of a joint return,

"(B) $75,000 in the case of an individual who is not married, and

"(C) $55,000 in the case of a married individual filing a separate return.

For purposes of this paragraph, marital status shall be determined under section 7703.

"(3) REMAINING CREDIT TREATED AS ATTRIBUTABLE TO DEPENDENT CARE TAX CREDIT.—The aggregate amount allowable under sections 21 and 24 after the application of paragraph (1) shall be treated as allowable solely under section 21 to the extent such amount does not exceed the amount allowable under section 21 (determined without regard to section 21(a)(3))."

(2) CONFORMING AMENDMENTS.—

(A) Subsection (a) of section 21 is amended by adding at the end the following new paragraph:

"(3) LIMITATION BASED ON ADJUSTED GROSS INCOME.—

"For limitation based on adjusted gross income, see section 26(c)."

(B) The section heading for section 26 is amended by inserting before the period "**; PHASEOUT OF CERTAIN CREDITS BASED ON INCOME**".

(C) The item relating to section 26 in the table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by inserting before the period "; phaseout of certain credits based on income".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

TITLE II—EDUCATION INCENTIVES

Subtitle A—Tax Benefits Relating to Education Expenses

SEC. 201. HOPE CREDIT FOR HIGHER EDUCATION TUITION AND RELATED EXPENSES.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to nonrefundable personal credits) is amended by inserting after section 25 the following new section:

"SEC. 25A. HIGHER EDUCATION TUITION AND RELATED EXPENSES.

"(a) ALLOWANCE OF CREDIT.—In the case of an individual, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year the amount equal to 50 percent of qualified tuition and related expenses paid by the taxpayer during such taxable year for education furnished during any academic period beginning in such year.

"(b) LIMITATIONS.—

"(1) DOLLAR LIMITATION.—The amount allowed as a credit under subsection (a) for any taxable year with respect to the qualified tuition and related expenses of any 1 individual shall not exceed $1,500.

"(2) CREDIT ALLOWED ONLY FOR 2 TAXABLE YEARS.—No credit shall be allowed under subsection (a) for a taxable year with respect to the qualified tuition and related expenses of an individual unless the taxpayer elects to have this section apply with respect to such individual for such year. An election under this paragraph shall not take effect with respect to an individual for any taxable year if an election under this paragraph (by the taxpayer or any other individual) is in effect with respect to such individual for any 2 prior taxable years.

"(3) CREDIT ALLOWED FOR YEAR ONLY IF INDIVIDUAL IS AT LEAST ½ TIME STUDENT FOR PORTION OF YEAR.—No credit shall be allowed under subsection (a) for a taxable year with respect to the qualified tuition and related expenses of an individual unless such individual is an eligible student for at least one academic period which begins during such year.

"(4) CREDIT ALLOWED ONLY FOR FIRST TWO YEARS OF POSTSECONDARY EDUCATION.—No credit shall be allowed under subsection (a) for a taxable year with respect to the qualified tuition and related expenses of an individual if the individual has completed (before the beginning of such taxable year) the first 2 years of postsecondary education at an eligible educational institution.

"(c) LIMITATION BASED ON MODIFIED ADJUSTED GROSS INCOME.—

"(1) IN GENERAL.—The amount which would (but for this subsection) be taken into account under subsection (a) for the taxable year shall be reduced (but not below zero) by the amount determined under paragraph (2).

"(2) AMOUNT OF REDUCTION.—The amount determined under this paragraph is the amount which bears the same ratio to the amount which would be so taken into account as—

"(A) the excess of—

"(i) the taxpayer's modified adjusted gross income for such taxable year, over

"(ii) $40,000 ($80,000 in the case of a joint return), bears to

"(B) $10,000 ($20,000 in the case of a joint return).

"(3) MODIFIED ADJUSTED GROSS INCOME.—The term 'modified adjusted gross income' means the adjusted gross income of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933.

"(d) DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED TUITION AND RELATED EXPENSES.—

"(A) IN GENERAL.—The term 'qualified tuition and related expenses' means tuition and fees required for the enrollment or attendance of—

"(i) the taxpayer,

"(ii) the taxpayer's spouse, or

"(iii) any dependent of the taxpayer with respect to whom the taxpayer is allowed a deduction under section 151,

at an eligible educational institution and books required for courses of instruction of such individual at such institution.

"(B) EXCEPTION FOR EDUCATION INVOLVING SPORTS, ETC.—Such term does not include expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program.

"(C) EXCEPTION FOR NONACADEMIC FEES.—Such term does not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

"(2) ELIGIBLE EDUCATIONAL INSTITUTION.—The term 'eligible educational institution' means an institution—

"(A) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of this section, and

"(B) which is eligible to participate in a program under title IV of such Act.

"(3) ELIGIBLE STUDENT.—The term 'eligible student' means, with respect to any academic period, a student who—

"(A) meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 (20 U.S.C. 1091(a)(1)), as in effect on the date of the enactment of this section, and

"(B) is carrying at least ½ the normal full-time work load for the course of study the student is pursuing.

"(4) OTHER TERMS RELATING TO THE HIGHER EDUCATION ACT.—The following terms shall have the meanings prescribed in regulations under section 481(g) of the Higher Education Act of 1965 (20 U.S.C. 1088(g)), as added by the Student Financial Aid Improvements Act of 1997:

"(A) Academic period.

"(B) Normal full-time workload.

"(C) First two years of postsecondary education.

"(e) TREATMENT OF EXPENSES PAID BY DEPENDENT.—If a deduction under section 151 with respect to an individual is allowed to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins—

"(1) no credit shall be allowed under subsection (a) to such individual for such individual's taxable year, and

"(2) qualified tuition and related expenses paid by such individual during such individual's taxable year shall be treated for purposes of this section as paid by such other taxpayer.

"(f) TREATMENT OF CERTAIN PREPAYMENTS.—If qualified tuition and related expenses are paid by the taxpayer during a taxable year for an academic period which begins during the first 3 months following such taxable year, such academic period shall be treated for purposes of this section as beginning during such taxable year.

"(g) SPECIAL RULES.—

"(1) IDENTIFICATION REQUIREMENT.—No credit shall be allowed under subsection (a) to a taxpayer with respect to the qualified tuition and related expenses of an individual unless the taxpayer includes the name and taxpayer identification number of such individual on the return of tax for the taxable year.

"(2) ADJUSTMENT FOR CERTAIN SCHOLARSHIPS, ETC.—The amount of qualified tuition and related expenses otherwise taken into account under subsection (a) with respect to an individual for an academic period shall be reduced (before the application of subsections (b) and (c)) by the sum of any amounts paid for the benefit of such individual which are allocable to such period as—

"(A) a qualified scholarship which is excludable from gross income under section 117,

"(B) an educational assistance allowance under chapter 30, 31, 32, 34, or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code, and

"(C) a payment (other than a gift, bequest, devise, or inheritance within the meaning of section 102(a)) for such individual's educational expenses, or attributable to such individual's enrollment at an eligible educational institution, which is excludable from gross income under any law of the United States.

"(3) DENIAL OF CREDIT IF STUDENT CONVICTED OF A FELONY DRUG OFFENSE.—No credit shall be allowed under subsection (a) for qualified tuition and related expenses for the enrollment or attendance of a student for any academic period if such student has been convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year with or within which such period ends.

"(4) DENIAL OF DOUBLE BENEFIT.—No credit shall be allowed under this section for any expense for which a deduction is allowed under any other provision of this chapter.

"(5) NO CREDIT FOR MARRIED INDIVIDUALS FILING SEPARATE RETURNS.—If the taxpayer is a married individual (within the meaning of section 7703), this section shall apply only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year.

"(6) NONRESIDENT ALIENS.—If the taxpayer is a nonresident alien individual for any portion of the taxable year, this section shall apply only if such individual is treated as a resident alien of the United States for purposes of this chapter by reason of an election under subsection (g) or (h) of section 6013.

"(h) INFLATION ADJUSTMENTS.—

"(1) DOLLAR LIMITATION ON AMOUNT OF CREDIT.—

"(A) IN GENERAL.—In the case of a taxable year beginning after 1998, the $1,500 amount in subsection (b)(1) shall be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

"(B) ROUNDING.—If any amount as adjusted under subparagraph (A) is not a multiple of $50, such amount shall be rounded to the next lowest multiple of $50.

"(2) INCOME LIMITS.—

"(A) IN GENERAL.—In the case of a taxable year beginning after 2000, the $40,000 and $80,000 amounts in subsection (c)(2) shall each be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 1999' for 'calendar year 1992' in subparagraph (B) thereof.

"(B) ROUNDING.—If any amount as adjusted under subparagraph (A) is not a multiple of $5,000, such amount shall be rounded to the next lowest multiple of $5,000.

"(i) REGULATIONS.—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out this section, including regulations providing for a recapture of credit allowed under this section in cases where there is a refund in a subsequent taxable year of any amount which was taken into account in determining the amount of such credit."

(b) EXTENSION OF PROCEDURES APPLICABLE TO MATHEMATICAL OR CLERICAL ERRORS.—Paragraph (2) of section 6213(g) (relating to the definition of mathematical or clerical errors) is amended by striking "and" at the end of subparagraph (G), by striking the period at the end of subparagraph (H) and inserting ", and", and by inserting after subparagraph (H) the following new subparagraph:

"(I) an omission of a correct TIN required under section 25A(g)(1) (relating to higher education tuition and related expenses) to be included on a return."

(c) RETURNS RELATING TO TUITION AND RELATED EXPENSES.—

(1) IN GENERAL.—Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons) is amended by inserting after section 6050R the following new section:

"SEC. 6050S. RETURNS RELATING TO HIGHER EDUCATION TUITION AND RELATED EXPENSES.

"(a) IN GENERAL.—Any person—

"(1) which is an eligible educational institution which receives payments for qualified tuition and related expenses with respect to any individual for any calendar year, or

"(2) which is engaged in a trade or business and which, in the course of such trade or business, makes payments during any calendar year to any individual which constitute reimbursements or refunds (or similar amounts) of qualified tuition and related expenses of such individual, shall make the return described in subsection (b) with respect to the individual at such time as the Secretary may by regulations prescribe.

"(b) FORM AND MANNER OF RETURNS.—A return is described in this subsection if such return—

"(1) is in such form as the Secretary may prescribe,

"(2) contains—

"(A) the name, address, and TIN of the individual with respect to whom payments described in subsection (a) were received from (or were paid to),

"(B) the name, address, and TIN of any individual certified by the individual described in subparagraph (A) as the taxpayer who will claim the individual as a dependent for purposes of the deduction allowable under section 151 for any taxable year ending with or within the calendar year, and

"(C) the—

"(i) aggregate amount of payments for qualified tuition and related expenses received with respect to the individual described in subparagraph (A) during the calendar year, and

"(ii) aggregate amount of reimbursements or refunds (or similar amounts) paid to such individual during the calendar year, and

"(D) such other information as the Secretary may prescribe.

"(c) APPLICATION TO GOVERNMENTAL UNITS.—For purposes of this section—

"(1) a governmental unit or any agency or instrumentality thereof shall be treated as a person, and

"(2) any return required under subsection (a) by such governmental entity shall be made by the officer or employee appropriately designated for the purpose of making such return.

"(d) STATEMENTS TO BE FURNISHED TO INDIVIDUALS WITH RESPECT TO WHOM INFORMATION IS REQUIRED.—Every person required to make a return under subsection (a) shall furnish to each individual whose name is required to be set forth in such return under subparagraph (A) or (B) of subsection (b)(2) a written statement showing—

"(1) the name, address, and phone number of the information contact of the person required to make such return, and

"(2) the aggregate amounts described in subsection (b)(2)(C).

The written statement required under the preceding sentence shall be furnished on or before January 31 of the year following the calendar year for which the return under subsection (a) was required to be made.

"(e) DEFINITIONS.—For purposes of this section, the terms 'eligible educational institution' and 'qualified tuition and related expenses' have the meanings given such terms by section 25A.

"(f) RETURNS WHICH WOULD BE REQUIRED TO BE MADE BY 2 OR MORE PERSONS.—Except to the extent provided in regulations prescribed by the Secretary, in the case of any amount received by any person on behalf of another person, only the person first receiving such amount shall be required to make the return under subsection (a).

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section. No penalties shall be imposed under section 6724 with respect to any return or statement required under this section until such time as such regulations are issued.”

(2) ASSESSABLE PENALTIES.—

(A) Subparagraph (B) of section 6724(d)(1) (relating to definitions) is amended by redesignating clauses (ix) through (xiv) as clauses (x) through (xv), respectively, and by inserting after clause (viii) the following new clause:

“(ix) section 6050S (relating to returns relating to payments for qualified tuition and related expenses),”.

(B) Paragraph (2) of section 6724(d) is amended by striking “or” at the end of the next to last subparagraph, by striking the period at the end of the last subparagraph and inserting “, or”, and by adding at the end the following new subparagraph:

“(Z) section 6050S(d) (relating to returns relating to qualified tuition and related expenses).”

(3) CLERICAL AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by inserting after the item relating to section 6050R the following new item:

“Sec. 6050S. Returns relating to higher education tuition and related expenses.”

(d) COORDINATION WITH SECTION 135.—Subsection (d) of section 135 is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by inserting after paragraph (1) the following new paragraph:

“(2) COORDINATION WITH HIGHER EDUCATION CREDIT.—The amount of the qualified higher education expenses otherwise taken into account under subsection (a) with respect to the education of an individual shall be reduced (before the application of subsection (b)) by the amount of such expenses which are taken into account in determining the credit allowable to the taxpayer or any other person under section 25A with respect to such expenses.”

(e) CLERICAL AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by inserting after the item relating to section 25 the following new item:

“Sec. 25A. Higher education tuition and related expenses.”

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to expenses paid after December 31, 1997 (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

SEC. 202. DEDUCTION FOR QUALIFIED HIGHER EDUCATION EXPENSES.

(a) DEDUCTION ALLOWED.— Part VII of subchapter B of chapter 1 (relating to additional itemized deductions for individuals) is amended by redesignating section 221 as section 222 and by inserting after section 220 the following new section:

“SEC. 221. QUALIFIED HIGHER EDUCATION EXPENSES.

“(a) ALLOWANCE OF DEDUCTION.—In the case of an individual, there shall be allowed as a deduction the amount of qualified higher education expenses paid by the taxpayer during the taxable year for education furnished during any academic period (within the meaning of section 25A) beginning in such year.

"(b) LIMITATIONS.—

"(1) ANNUAL LIMIT.—The amount allowed as a deduction under subsection (a) for any taxable year with respect to expenses paid for education furnished to any 1 individual shall not exceed the lesser of—

"(A) $10,000, or

"(B) the amount includible in the taxpayer's gross income for such taxable year by reason of a distribution from a qualified tuition program (as defined in section 529), or an education investment account (as defined in section 530), the beneficiary of which is such individual.

"(2) AGGREGATE LIMIT.—The amount allowed as a deduction under subsection (a) to the taxpayer or any other individual with respect to expenses paid for education furnished to any 1 individual shall not exceed $40,000 for all taxable years.

"(3) DEDUCTION ALLOWED FOR YEAR ONLY IF INDIVIDUAL IS AT LEAST ½ TIME STUDENT FOR PORTION OF YEAR.—No deduction shall be allowed under subsection (a) for a taxable year with respect to the qualified higher education expenses of an individual unless such individual is an eligible student (as defined in section 25A(d)(3)) for at least one academic period which begins during such year.

"(4) DEDUCTION ALLOWED ONLY FOR FIRST 4 YEARS OF POSTSECONDARY EDUCATION.—No deduction shall be allowed under subsection (a) for a taxable year with respect to the qualified higher education expenses of an individual if the individual has completed (before the beginning of such taxable year) the equivalent of the first 4 years of postsecondary education at an eligible educational institution (determined under the rules of section 25A).

"(5) COORDINATION WITH CREDIT FOR HIGHER EDUCATION EXPENSES.—No deduction shall be allowed under this section for a taxable year with respect to the qualified higher education expenses of an individual if an election is in effect under section 25A with respect to such individual for such taxable year.

"(c) QUALIFIED HIGHER EDUCATION EXPENSES.—The term 'qualified higher education expenses' means qualified higher education expenses (as defined in section 529) for the education of—

"(1) the taxpayer,

"(2) the taxpayer's spouse, or

"(3) any dependent of the taxpayer with respect to whom the taxpayer is allowed a deduction under section 151,

at an eligible educational institution (as defined in section 529(e)(5)).

"(d) TREATMENT OF EXPENSES PAID BY DEPENDENT.—If a deduction under section 151 with respect to an individual is allowed to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins—

"(1) no deduction shall be allowed under subsection (a) to such individual for such individual's taxable year, and

"(2) qualified higher education expenses paid by such individual during such individual's taxable year shall be treated for purposes of this section as paid by such other taxpayer.

"(e) COORDINATION WITH AMOUNTS INCLUDIBLE IN GROSS INCOME UNDER SECTION 529 OR 530.—If any deduction is allowed under subsection (a) with respect to the qualified higher education expenses of an individual with respect to whom the taxpayer is allowed a deduction under section 151(c), any amount which would (but for this subsection) be includible in such individual's gross income by reason of section 529 or section 530 shall be includible in the gross income of the taxpayer and not such individual.

"(f) ADJUSTMENT FOR CERTAIN SCHOLARSHIPS, ETC.—The amount of qualified higher education expenses otherwise taken into account under subsection (a) with respect to an individual for an academic period shall be reduced (before the application of subsection (b)) by the sum of—

"(1) the aggregate amount of the reductions under section 25A(g)(2) for the benefit of such individual for such period, and

"(2) the amount excludable from gross income under section 135 by reason of such expenses with respect to such individual which are allocable to such period.

"(g) DENIAL OF DEDUCTION IF STUDENT CONVICTED OF A FELONY DRUG OFFENSE.—No deduction shall be allowed under subsection (a) for qualified higher education expenses for the enrollment or attendance of a student for any academic period if such student has been convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year with or within which such period ends.

"(h) DENIAL OF DOUBLE BENEFIT.—No deduction shall be allowed under subsection (a) for any expense for which a deduction is allowed to the taxpayer under any other provision of this chapter."

(b) DEDUCTION ALLOWED WHETHER OR NOT TAXPAYER ITEMIZES OTHER DEDUCTIONS.—

(1) IN GENERAL.—Subsection (b) of section 63 is amended by striking "and" at the end of paragraph (1), by striking the period at the end of paragraph (2) and inserting ", and", and by adding at the end the following new paragraph:

"(3) the deduction allowed by section 221 (relating to deduction for qualified higher education expenses)."

(2) CONFORMING AMENDMENT.—Subsection (d) of section 63 is amended by striking "and" at the end of paragraph (1), by striking the period at the end of paragraph (2) and inserting ", and", and by adding at the end the following new paragraph:

"(3) the deduction allowed by section 221 (relating to deduction for qualified higher education expenses)."

(c) PHASEOUT OF EXCLUSION FOR QUALIFIED TUITION REDUCTIONS.—Subsection (d) of section 117 is amended by redesignating the last paragraph as paragraph (4) and by adding at the end the following new paragraph:

"(5) PHASEOUT OF EXCLUSION.—

"(A) TERMINATION.—Paragraph (1) shall not apply to any qualified tuition reduction for any course of instruction beginning after December 31, 2001.

"(B) PHASEOUT.—The amount excludable from gross income under paragraph (1) for any course of instruction beginning in a calendar year after 1997 and before 2002 shall not exceed the applicable percentage (determined in accordance with the following table) for such calendar year of the amount which would be so excludable but for this subparagraph:

In the case of calendar year:	**The applicable percentage is:**
1998	80
1999	60
2000	40
2001	20."

(d) TECHNICAL AMENDMENTS.—

(1) Subparagraph (A) of section 529(e)(3) is amended by inserting "(except as provided in section 221(e))" after "distributee".

(2) The table of sections for part VII of subchapter B of chapter 1 is amended by striking the item relating to section 221 and inserting:

"Sec. 221. Qualified higher education expenses.
"Sec. 222. Cross reference."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to expenses paid after December 31, 1997 (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

SEC. 203. PENALTY-FREE WITHDRAWALS FROM INDIVIDUAL RETIREMENT PLANS FOR HIGHER EDUCATION EXPENSES.

(a) IN GENERAL.—Paragraph (2) of section 72(t) (relating to exceptions to 10-percent additional tax on early distributions from qualified retirement plans) is amended by adding at the end the following new subparagraph:

"(E) DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR HIGHER EDUCATION EXPENSES.—Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B)."

(b) DEFINITION.—Section 72(t) is amended by adding at the end the following new paragraph:

"(7) QUALIFIED HIGHER EDUCATION EXPENSES.—For purposes of paragraph (2)(E)—

"(A) IN GENERAL.—The term 'qualified higher education expenses' means qualified higher education expenses (as defined in section 529(e)(3) without regard to subparagraph (C) thereof) for education furnished to—

"(i) the taxpayer,

"(ii) the taxpayer's spouse, or

“(iii) any child (as defined in section 151(c)(3)) or grandchild of the taxpayer or the taxpayer’s spouse,

at an eligible educational institution (as defined in section 529(e)(5)).

“(B) COORDINATION WITH OTHER BENEFITS.—The amount of qualified higher education expenses for any taxable year shall be reduced as provided in section 25A(g)(2).”

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 1997, with respect to expenses paid after such date (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

SEC. 204. EXPENSES FOR EDUCATION WHICH SUPPLEMENTS ELEMENTARY AND SECONDARY EDUCATION.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to nonrefundable personal credits) is amended by inserting after section 25A, as added by this title, the following new section:

“SEC. 25B. EXPENSES FOR EDUCATION WHICH SUPPLEMENTS ELEMENTARY AND SECONDARY EDUCATION.

“(a) ALLOWANCE OF CREDIT.—In the case of an individual, there shall be allowed a credit against the tax imposed by this chapter for the taxable year an amount equal to 50 percent of the qualifying educational assistance expenses paid by the taxpayer during the taxable year.

“(b) LIMITATIONS.—

“(1) DOLLAR LIMITATION.—The amount allowed as a credit under subsection (a) for any taxable year with respect to the qualified educational assistance expenses of any 1 individual shall not exceed $150.

“(2) REDUCTION OF CREDIT BASED ON ADJUSTED GROSS INCOME.—

“(A) IN GENERAL.—The aggregate amount which would (but for this paragraph) be allowed by this section shall be reduced (but not below zero) by $25 for each $1,000 (or fraction thereof) by which the taxpayer’s modified adjusted gross income exceeds the threshold amount. For purposes of the preceding sentence, the term ‘modified adjusted gross income’ means adjusted gross income increased by any amount excluded from gross income under section 911, 931, or 933.

“(B) THRESHOLD AMOUNT.—For purposes of subparagraph (A), the term ‘threshold amount’ means—

“(i) $80,000 in the case of a joint return,

“(ii) $50,000 in the case of an individual who is not married, and

“(iii) $40,000 in the case of a married individual filing a separate return.

For purposes of this subparagraph, marital status shall be determined under section 7703.

“(c) QUALIFIED EDUCATIONAL ASSISTANCE EXPENSES.—For purposes of this section—

“(1) IN GENERAL.—The term ‘qualified educational assistance expenses’ means amounts paid to a qualified entity to provide supplementary education to any dependent (within the meaning of section 152) of the taxpayer—

"(A) who is less than 18 years of age as of the close of the taxable year, and

"(B) who is enrolled as a full-time student in an elementary or secondary school.

"(2) SUPPLEMENTARY EDUCATION.—For purposes of paragraph (1), supplementary education is education provided with respect to reading, mathematics, or any subject that the dependent student is studying at the time in elementary or secondary school classes. Eligible courses of study shall not include courses providing assistance with respect to preparation for college entrance examinations.

"(3) QUALIFIED ENTITY.—The term 'qualified entity' means a person that is accredited as a supplementary education service provider by an accreditation organization that is recognized by the Secretary of Education or by any other agency, association, or group that is certified by the Secretary for purposes of this section."

(b) CLERICAL AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1 is amended by inserting after the item relating to section 25A the following new item:

"Sec. 25B. Expenses for education which supplements elementary and secondary education.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

Subtitle B—Expanded Education Investment Savings Opportunities

SEC. 211. ELIGIBLE EDUCATIONAL INSTITUTIONS PERMITTED TO MAINTAIN QUALIFIED TUITION PROGRAMS; OTHER MODIFICATIONS OF QUALIFIED STATE TUITION PROGRAMS.

(a) ELIGIBLE EDUCATIONAL INSTITUTIONS PERMITTED TO MAINTAIN QUALIFIED TUITION PROGRAMS.—Paragraph (1) of section 529(b) (defining qualified State tuition program) is amended by inserting "or by one or more eligible educational institutions" after "maintained by a State or agency or instrumentality thereof".

(b) QUALIFIED HIGHER EDUCATION EXPENSES TO INCLUDE ROOM AND BOARD.—Paragraph (3) of section 529(e) (defining qualified higher education expenses) is amended to read as follows:

"(3) QUALIFIED HIGHER EDUCATION EXPENSES.—

"(A) IN GENERAL.—The term 'qualified higher education expenses' means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible education institution.

"(B) ROOM AND BOARD INCLUDED FOR STUDENTS WHO ARE AT LEAST HALF-TIME.—In the case of an individual who is an eligible student (as defined in section 25A(d)(3)) for any academic period, such term shall also include reasonable costs for such period (as determined under the qualified tuition program) incurred by the designated beneficiary for room and board while attending such institution. The amount treated as qualified higher education expenses by reason of the preceding sentence shall not exceed the minimum amount (applicable to the student) included for room and board for such period in the cost of attendance (as defined in section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087ll, as in effect on the date of the enactment of this paragraph) for the eligible educational institution for such period.

"(C) EXCLUSION FOR GRADUATE LEVEL COURSES.—Such term shall not include expenses for any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree. Such courses shall not be taken into account in determining whether an individual is described in subsection (f)(3)(A)."

(c) ADDITIONAL MODIFICATIONS.—

(1) MEMBER OF FAMILY.—Paragraph (2) of section 529(e) (relating to other definitions and special rules) is amended to read as follows:

"(2) MEMBER OF FAMILY.—The term 'member of the family' means—

"(A) an individual who bears a relationship to another individual which is a relationship described in paragraphs (1) through (8) of section 152(a), and

"(B) the spouse of any individual described in subparagraph (A)."

(2) ELIGIBLE EDUCATIONAL INSTITUTION.—Section 529(e) is amended by adding at the end the following:

"(5) ELIGIBLE EDUCATIONAL INSTITUTION.—The term 'eligible educational institution' means an institution—

"(A) which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of this paragraph, and

"(B) which is eligible to participate in a program under title IV of such Act."

(3) NO CONTRIBUTIONS AFTER BENEFICIARY ATTAINS AGE 18; DISTRIBUTIONS REQUIRED IN CERTAIN CASES.—Subsection (b) of section 529 (as amended by subsection (f) of this section) is amended by adding at the end the following new paragraph:

"(7) RESTRICTIONS RELATING TO AGE OF BENEFICIARY; COMPLETION OF EDUCATION.—

"(A) IN GENERAL.—A program shall be treated as a qualified tuition program only if—

"(i) no contribution is accepted on behalf of a designated beneficiary after the date on which such beneficiary attains age 18, and

"(ii) any balance to the credit of a designated beneficiary (if any) on the account termination date shall be distributed within 30 days after such date to such beneficiary (or in the case of death, the estate of the beneficiary).

"(B) ACCOUNT TERMINATION DATE.—For purposes of subparagraph (A), the term 'account termination date' means whichever of the following dates is the earliest:

"(i) The date on which the designated beneficiary completes the equivalent of 4 years of post-secondary education (whether or not at the same eligible educational institution).

"(ii) The date on which the designated beneficiary attains age 30.

"(iii) The date on which the designated beneficiary dies."

(4) ESTATE AND GIFT TAX TREATMENT.—

(A) GIFT TAX TREATMENT.—

(i) Paragraph (2) of section 529(c) is amended to read as follows:

"(2) GIFT TAX TREATMENT OF CONTRIBUTIONS.—For purposes of chapters 12 and 13, any contribution to a qualified tuition program on behalf of any designated beneficiary—

"(A) shall be treated as a completed gift to such beneficiary which is not a future interest in property, and

"(B) shall not be treated as a qualified transfer under section 2503(e)."

(ii) Paragraph (5) of section 529(c) is amended to read as follows:

"(5) OTHER GIFT TAX RULES.—For purposes of chapters 12 and 13—

"(A) TREATMENT OF DISTRIBUTIONS.—In no event shall a distribution from a qualified tuition program be treated as a taxable gift.

"(B) TREATMENT OF DESIGNATION OF NEW BENEFICIARY.—The taxes imposed by chapters 12 and 13 shall apply to a transfer by reason of a change in the designated beneficiary under the program (or a rollover to the account of a new beneficiary) only if the new beneficiary is a generation below the generation of the old beneficiary (determined in accordance with section 2651)."

(B) ESTATE TAX TREATMENT.—Paragraph (4) of section 529(c) is amended to read as follows:

"(4) ESTATE TAX TREATMENT.—

"(A) IN GENERAL.—No amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program.

"(B) AMOUNTS INCLUDIBLE IN ESTATE OF DESIGNATED BENEFICIARY IN CERTAIN CASES.—Subparagraph (A) shall not apply to amounts distributed on account of the death of a beneficiary."

(5) LIMITATION ON CONTRIBUTIONS TO QUALIFIED TUITION PROGRAMS NOT MAINTAINED BY A STATE.—Subsection (b) of section 529 is amended by adding at the end the following new paragraph:

"(9) LIMITATION ON CONTRIBUTIONS TO QUALIFIED TUITION PROGRAMS NOT MAINTAINED BY A STATE.—In the case of a program not maintained by a State or agency or instrumentality thereof, such program shall not be treated as a qualified tuition program unless it limits the annual contribution to the program on behalf of a designated beneficiary to an amount equal to the lesser of—

"(A) $5,000, or

"(B) the excess of—

"(i) $50,000, over

"(ii) the aggregate amount contributed to such program on behalf of such beneficiary for all prior taxable years."

(d) ADDITIONAL TAX ON AMOUNTS NOT USED FOR HIGHER EDUCATION EXPENSES.—Section 529 is amended by adding at the end the following new subsection:

"(f) IMPOSITION OF ADDITIONAL TAX.—

"(1) IN GENERAL.—The tax imposed by this chapter for any taxable year on any taxpayer who receives a payment or distribution from a qualified tuition program which is includible in gross income shall be increased by 10 percent of the amount which is so includible.

"(2) EXCEPTIONS.—Paragraph (1) shall not apply if the payment or distribution is—

"(A) used for qualified higher education expenses of the designated beneficiary,

"(B) made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary,

"(C) attributable to the designated beneficiary's being disabled (within the meaning of section 72(m)(7)), or

"(D) made on account of a scholarship, allowance, or payment described in subparagraph (A), (B), or (C) of section 135(d)(1) received by the account holder to the extent the amount of the payment or distribution does not exceed the amount of the scholarship, allowance, or payment.

"(3) EXCESS CONTRIBUTIONS RETURNED BEFORE DUE DATE OF RETURN.—In the case of a qualified tuition program not maintained by a State or any agency or instrumentality thereof, paragraph (1) shall not apply to the distribution to a contributor of any contribution made during a taxable year on behalf of a designated beneficiary to the extent that such contribution exceeds the limitation in section 4973(e) if—

"(A) such distribution is received on or before the day prescribed by law (including extensions of time) for filing such contributor's return for such taxable year, and

"(B) such distribution is accompanied by the amount of net income attributable to such excess contribution.

Any net income described in subparagraph (B) shall be included in the gross income of the contributor for the taxable year in which such excess contribution was made."

(e) COORDINATION WITH EDUCATION SAVINGS BOND.—Section 135(c)(2) (defining qualified higher education expenses) is amended by adding at the end the following:

"(C) CONTRIBUTIONS TO QUALIFIED TUITION PROGRAM.—Such term shall include any contribution to a qualified tuition program (as defined in section 529) on behalf of a designated beneficiary (as defined in such section) who is an individual described in subparagraph (A); but there shall be no increase in the investment in the contract for purposes of applying section 72 by reason of the portion of such contribution which is not includible in gross income by reason of this subparagraph.”

(f) TAX ON EXCESS CONTRIBUTIONS.—

(1) IN GENERAL.—Subsection (a) of section 4973 is amended by striking “or” at the end of paragraph (2) and by inserting after paragraph (3) the following new paragraphs:

“(4) a qualified tuition program (as defined in section 529) not maintained by a State or any agency or instrumentality thereof, or

“(5) an education investment account (as defined in section 530),”.

(2) EXCESS CONTRIBUTIONS DEFINED.—Section 4973 is amended by adding at the end the following new subsection:

“(e) EXCESS CONTRIBUTIONS TO PRIVATE QUALIFIED TUITION PROGRAM AND EDUCATION INVESTMENT ACCOUNTS.—For purposes of this section—

“(1) IN GENERAL.—In the case of private education investment accounts maintained for the benefit of any 1 beneficiary, the term ‘excess contributions’ means the amount by which the amount contributed for the taxable year to such accounts exceeds the lesser of—

“(A) the excess of—

“(i) $5,000, over

“(ii) the aggregate amount contributed to all qualified tuition programs (as defined in section 529) maintained by a State or any agency or instrumentality thereof on behalf of such beneficiary for such taxable year, or

“(B) the excess of—

“(i) $50,000, over

“(ii) the sum of—

“(I) the aggregate amount contributed to such accounts for all prior taxable years, and

“(II) the aggregate amount contributed to all qualified tuition programs (as defined in section 529) maintained by a State or any agency or instrumentality thereof on behalf of such beneficiary for such taxable year and all prior taxable years.

“(2) PRIVATE EDUCATION INVESTMENT ACCOUNT.—For purposes of paragraph (1), the term ‘private education investment account’ means—

“(A) a qualified tuition program (as defined in section 529) not maintained by a State or any agency or instrumentality thereof, and

“(B) an education investment account (as defined in section 530).

“(3) SPECIAL RULES.—For purposes of paragraph (1), the following contributions shall not be taken into account:

“(A) Any contribution which is distributed out of the education investment account in a distribution to which section 530(c)(3)(B) applies.

“(B) Any contribution to a qualified tuition program (as so defined) described in section 530(b)(2)(B) from any such account.

"(C) Any rollover contribution."

(g) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 26(b) is amended by redesignating subparagraphs (E) through (P) as subparagraphs (F) through (Q), respectively, and by inserting after subparagraph (D) the following new subparagraph:

"(E) section 529(f) (relating to additional tax on certain distributions from qualified tuition programs),".

(2) The text of section 529 is amended by striking "qualified State tuition program" each place it appears and inserting "qualified tuition program".

(3) Subsection (b) of section 529 is amended by striking paragraph (3) and by redesignating paragraphs (4) through (7) as paragraphs (3) through (6), respectively.

(4)(A) The section heading of section 529 is amended to read as follows:

"SEC. 529. QUALIFIED TUITION PROGRAMS."

(B) The item relating to section 529 in the table of sections for part VIII of subchapter F of chapter 1 is amended by striking "State".

(5)(A) The heading for part VIII of subchapter F of chapter 1 is amended to read as follows:

"PART VIII—HIGHER EDUCATION SAVINGS ENTITIES".

(B) The table of parts for subchapter F of chapter 1 is amended by striking the item relating to part VIII and inserting:

"Part VIII. Higher education savings entities."

(h) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall take effect on January 1, 1998.

(2) EXPENSES TO INCLUDE ROOM AND BOARD, ETC.—The amendments made by subsection (b) and (c)(2) shall apply to distributions after December 31, 1997, with respect to expenses paid after such date (in taxable years ending after such date), for education furnished in academic periods beginning after such date.

(3) PENALTY FOR NONEDUCATION WITHDRAWALS.—The amendment made by subsection (d) shall apply to distributions after December 31, 1997.

(4) COORDINATION WITH EDUCATION SAVINGS BONDS.—The amendment made by subsection (e) shall apply to taxable years beginning after December 31, 1997.

(5) ESTATE AND GIFT TAX CHANGES.—

(A) GIFT TAX CHANGES.—Paragraphs (2) and (5) of section 529(c) of the Internal Revenue Code of 1986, as amended by this section, shall apply to transfers (including designations of new beneficiaries) made after the date of the enactment of this Act.

(B) ESTATE TAX CHANGES.—Paragraph (4) of such section 529(c) shall apply to estates of decedents dying after June 8, 1997.

SEC. 212. EDUCATION INVESTMENT ACCOUNTS.

(a) IN GENERAL.—Part VIII of subchapter F of chapter 1 (relating to qualified State tuition programs) is amended by adding at the end the following new section:

"SEC. 530. EDUCATION INVESTMENT ACCOUNTS.

"(a) GENERAL RULE.—An education investment account shall be exempt from taxation under this subtitle. Notwithstanding the preceding sentence, the education investment account shall be subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business income of charitable organizations).

"(b) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) EDUCATION INVESTMENT ACCOUNT.—The term 'education investment account' means a trust created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder, but only if the written governing instrument creating the trust meets the following requirements:

"(A) No contribution will be accepted—

"(i) unless it is in cash,

"(ii) after the date on which the account holder attains age 18, or

"(iii) in excess of $5,000 for the taxable year.

"(B) The trustee is a bank (as defined in section 408(n)) or another person who demonstrates to the satisfaction of the Secretary that the manner in which that person will administer the trust will be consistent with the requirements of this section.

"(C) No part of the trust assets will be invested in life insurance contracts.

"(D) The assets of the trust shall not be commingled with other property except in a common trust fund or common investment fund.

"(E) Any balance in the account will be distributed as required under section 529(b)(8)(B) (as if such account were a qualified tuition program).

For $50,000 limit on aggregate contributions to accounts, see section 4973(e).

"(2) QUALIFIED HIGHER EDUCATION EXPENSES.—

"(A) IN GENERAL.—The term 'qualified higher education expenses' has the same meaning given such term by section 529(e)(3).

"(B) QUALIFIED TUITION PROGRAMS.—Such term shall include amounts paid or incurred to purchase tuition credits or certificates, or to make contributions to an account, under a qualified tuition program (as defined in section 529(b)) for the benefit of the account holder.

"(3) ELIGIBLE EDUCATIONAL INSTITUTION.—The term 'eligible educational institution' has the meaning given such term by section 529(e)(5).

"(4) ACCOUNT HOLDER.—The term 'account holder' means the individual for whose benefit the education investment account is established.

"(c) TAX TREATMENT OF DISTRIBUTIONS.—

"(1) IN GENERAL.—Any amount paid or distributed shall be includible in gross income as required by section 529(c)(3) (determined as if such account were a qualified tuition program).

"(2) SPECIAL RULES FOR APPLYING ESTATE AND GIFT TAXES WITH RESPECT TO ACCOUNT.—Rules similar to the rules of paragraphs (2), (4), and (5) of section 529(c) shall apply for purposes of this section.

"(3) ADDITIONAL TAX FOR DISTRIBUTIONS NOT USED FOR EDUCATIONAL EXPENSES.—

"(A) IN GENERAL.—The tax imposed by section 529(f) shall apply to payments and distributions from an education investment account in the same manner as such tax applies to qualified tuition programs (as defined in section 529).

"(B) EXCESS CONTRIBUTIONS RETURNED BEFORE DUE DATE OF RETURN.—Subparagraph (A) shall not apply to the distribution to a contributor of any contribution paid during a taxable year to an education investment account to the extent that such contribution exceeds the limitation in section 4973(e) if such distribution (and the net income with respect to such excess contribution) meet requirements comparable to the requirements of section 529(f)(3).

"(4) ROLLOVER CONTRIBUTIONS.—Paragraph (1) shall not apply to any amount paid or distributed from an education investment account to the extent that the amount received is paid into another education investment account for the benefit of the account holder or a member of the family (within the meaning of section 529(e)(2)) of the account holder not later than the 60th day after the date of such payment or distribution. The preceding sentence shall not apply to any payment or distribution if it applied to any prior payment or distribution during the 12-month period ending on the date of the payment or distribution.

"(5) CHANGE IN ACCOUNT HOLDER.—Any change in the account holder of an education investment account shall not be treated as a distribution for purposes of paragraph (1) if the new account holder is a member of the family (as so defined) of the old account holder.

"(6) SPECIAL RULES FOR DEATH AND DIVORCE.—Rules similar to the rules of paragraphs (7) and (8) of section 220(f) shall apply.

"(d) TAX TREATMENT OF ACCOUNTS.—Rules similar to the rules of paragraphs (2) and (4) of section 408(e) shall apply to any education investment account.

"(e) COMMUNITY PROPERTY LAWS.—This section shall be applied without regard to any community property laws.

"(f) CUSTODIAL ACCOUNTS.—For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in section 408(n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an account described in subsection (b)(1). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

"(g) REPORTS.—The trustee of an education investment account shall make such reports regarding such account to the Secretary and to the account holder with respect to contributions, distributions, and such other matters as the Secretary may require under regulations. The reports required by this subsection shall be filed at such time and in such manner and furnished to such individuals at such time and in such manner as may be required by those regulations."

(b) TAX ON PROHIBITED TRANSACTIONS.—

(1) IN GENERAL.—Paragraph (1) of section 4975(e) (relating to prohibited transactions) is amended by striking "or" at the end of subparagraph (D), by redesignating subparagraph (E) as subparagraph (F), and by inserting after subparagraph (D) the following new subparagraph:

"(E) an education investment account described in section 530, or".

(2) SPECIAL RULE.—Subsection (c) of section 4975 is amended by adding at the end of subsection (c) the following new paragraph:

"(5) SPECIAL RULE FOR EDUCATION INVESTMENT ACCOUNTS.—An individual for whose benefit an education investment account is established and any contributor to such account shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if section 530(d) applies with respect to such transaction."

(c) FAILURE TO PROVIDE REPORTS ON EDUCATION INVESTMENT ACCOUNTS.—

(1) IN GENERAL.—Paragraph (2) of section 6693(a) (relating to failure to provide reports on individual retirement accounts or annuities) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following new subparagraph:

"(C) section 530(g) (relating to education investment accounts)."

(2) CLERICAL AMENDMENT.—The section heading for section 6693 is amended by striking "**INDIVIDUAL RETIREMENT**" and inserting "**CERTAIN TAX-FAVORED**".

(d) TECHNICAL AMENDMENTS.—

(1) Subparagraph (F) of section 26(b)(2), as added by the preceding section, is amended by inserting before the comma "and section 530(c)(3) (relating to additional tax on certain distributions from education investment accounts)".

(2) Subparagraph (C) of section 135(c)(2), as added by the preceding section, is amended by inserting ", or to an education investment account (as defined in section 530) on behalf of an

account holder (as defined in such section)," after "(as defined in such section)".

(3) The table of sections for part VIII of subchapter F of chapter 1 is amended by adding at the end the following new item:

"Sec. 530. Education investment accounts."

(4) The item relating to section 6693 in the table of sections for part I of subchapter B of chapter 68 is amended by striking "individual retirement" and inserting "certain tax-favored".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

Subtitle C—Other Education Initiatives

SEC. 221. EXTENSION OF EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE.

(a) IN GENERAL.—Subsection (d) of section 127 (relating to educational assistance programs) is amended to read as follows:

"(d) TERMINATION.—This section shall not apply to expenses paid with respect to courses of instruction beginning after December 31, 1997."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1996.

SEC. 222. INCREASE IN LIMITATION ON QUALIFIED 501(C)(3) BONDS OTHER THAN HOSPITAL BONDS.

(a) IN GENERAL.—The text of paragraph (1) of section 145(b) is amended by striking "$150,000,000." and inserting "the limitation determined in accordance with the following table:

In the case of calendar year:	The limitation is:
1998	$160,000,000
1999	170,000,000
2000	180,000,000
2001	190,000,000
2002 or thereafter	200,000,000."

(b) CONFORMING AMENDMENT.—The heading for subsection (b) of section 145 is amended by striking "$150,000,000".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1998.

SEC. 223. CONTRIBUTIONS OF COMPUTER TECHNOLOGY AND EQUIPMENT FOR ELEMENTARY OR SECONDARY SCHOOL PURPOSES.

(a) CONTRIBUTIONS OF COMPUTER TECHNOLOGY AND EQUIPMENT FOR ELEMENTARY OR SECONDARY SCHOOL PURPOSES.—Subsection (e) of section 170 is amended by adding at the end the following new paragraph:

"(6) SPECIAL RULE FOR CONTRIBUTIONS OF COMPUTER TECHNOLOGY AND EQUIPMENT FOR ELEMENTARY OR SECONDARY SCHOOL PURPOSES.—

"(A) LIMIT ON REDUCTION.—In the case of a qualified elementary or secondary educational contribution, the reduction under paragraph (1)(A) shall be no greater than the amount determined under paragraph (3)(B).

“(B) QUALIFIED ELEMENTARY OR SECONDARY EDUCATIONAL CONTRIBUTION.—For purposes of this paragraph, the term ‘qualified elementary or secondary educational contribution’ means a charitable contribution by a corporation of any computer technology or equipment, but only if—

“(i) the contribution is to—

“(I) an educational organization described in subsection (b)(1)(A)(ii), or

“(II) an entity described in section 501(c)(3) and exempt from tax under section 501(a) (other than an entity described in subclause (I)) that is organized primarily for purposes of supporting elementary and secondary education,

“(ii) the contribution is made not later than 2 years after the date the taxpayer acquired the property (or in the case of property constructed by the taxpayer, the date the construction of the property is substantially completed),

“(iii) substantially all of the use of the property by the donee is for use within the United States for educational purposes in any of the grades K–12 that are related to the purpose or function of the organization or entity,

“(iv) the property is not transferred by the donee in exchange for money, other property, or services, except for shipping, installation and transfer costs,

“(v) the property will fit productively into the entity’s education plan, and

“(vi) the entity’s use and disposition of the property will be in accordance with the provisions of clauses (iii) and (iv).

“(C) CONTRIBUTION TO PRIVATE FOUNDATION.—A contribution by a corporation of any computer technology or equipment to a private foundation (as defined in section 509) shall be treated as a qualified elementary or secondary educational contribution for purposes of this paragraph if—

“(i) the contribution to the private foundation satisfies the requirements of clauses (ii) and (iv) of subparagraph (B), and

“(ii) within 30 days after such contribution, the private foundation—

“(I) contributes the property to an entity described in clause (i) of subparagraph (B) that satisfies the requirements of clauses (iii) through (vi) of subparagraph (B), and

“(II) notifies the donor of such contribution.

“(D) SPECIAL RULE RELATING TO CONSTRUCTION OF PROPERTY.—For the purposes of this paragraph, the rules of paragraph (4)(C) shall apply.

“(E) DEFINITIONS.—For the purposes of this paragraph—

“(i) COMPUTER TECHNOLOGY OR EQUIPMENT.—The term ‘computer technology or equipment’ means computer software (as defined by section 197(e)(3)(B)), computer or peripheral equipment (as defined by section 168(i)(2)(B)), and fiber optic cable related to computer use.

"(ii) CORPORATION.—The term 'corporation' has the meaning given to such term by paragraph (4)(D)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after the calendar year in which this Act is enacted.

SEC. 224. TREATMENT OF CANCELLATION OF CERTAIN STUDENT LOANS.

(a) CERTAIN DIRECT STUDENT LOANS THE REPAYMENT OF WHICH IS INCOME CONTINGENT.—Paragraph (1) of section 108(f) is amended by striking "any student loan if" and all that follows and inserting "any student loan if—

"(A) such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers, or

"(B) in the case of a loan made under part D of title IV of the Higher Education Act of 1965 which has a repayment schedule established under section 455(e)(4) of such Act (relating to income contingent repayments), such discharge is after the maximum repayment period under such loan (as prescribed under such part)."

(b) CERTAIN LOANS BY EXEMPT ORGANIZATIONS.—

(1) IN GENERAL.—Paragraph (2) of section 108(f) (defining student loan) is amended by striking "or" at the end of subparagraph (B) and by striking subparagraph (D) and inserting the following:

"(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made—

"(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

"(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term 'student loan' includes any loan made by an educational organization so described or by an organization exempt from tax under section 501(a) to refinance a loan meeting the requirements of the preceding sentence."

(2) EXCEPTION FOR DISCHARGES ON ACCOUNT OF SERVICES PERFORMED FOR CERTAIN LENDERS.—Subsection (f) of section 108 is amended by adding at the end the following new paragraph:

"(3) EXCEPTION FOR DISCHARGES ON ACCOUNT OF SERVICES PERFORMED FOR CERTAIN LENDERS.—Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) (or by an organization described in paragraph (2)(E) from funds provided by an organization described in paragraph (2)(D)) if the discharge is on account of services performed for either such organization."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to discharges of indebtedness after the date of the enactment of this Act.

TITLE III—SAVINGS AND INVESTMENT INCENTIVES

Subtitle A—Retirement Savings

SEC. 301. ESTABLISHMENT OF AMERICAN DREAM IRA.

(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by inserting after section 408 the following new section:

"SEC. 408A. AMERICAN DREAM IRA.

"(a) GENERAL RULE.—Except as provided in this section, an American Dream IRA shall be treated for purposes of this title in the same manner as an individual retirement plan.

"(b) AMERICAN DREAM IRA.—For purposes of this title, the term 'American Dream IRA' or 'AD IRA' means an individual retirement plan (as defined in section 7701(a)(37)) which is designated at the time of the establishment of the plan as an American Dream IRA. Such designation shall be made in such manner as the Secretary may prescribe.

"(c) TREATMENT OF CONTRIBUTIONS.—

"(1) NO DEDUCTION ALLOWED.—No deduction shall be allowed under section 219 for a contribution to an AD IRA.

"(2) CONTRIBUTION LIMIT.—

"(A) IN GENERAL.—The aggregate amount of contributions for any taxable year to all AD IRAs maintained for the benefit of an individual shall not exceed $2,000.

"(B) INFLATION ADJUSTMENT.—In the case of taxable years beginning in a calendar year after 1998, the $2,000 amount contained in subparagraph (A) shall be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If the amount as adjusted under the preceding sentence is not a multiple of $50, such amount shall be rounded to the next lowest multiple of $50.

"(3) CONTRIBUTIONS PERMITTED AFTER AGE 70½.—Contributions to an AD IRA may be made even after the individual for whom the account is maintained has attained age 70½.

"(4) Mandatory distribution rules not to apply, etc.—

"(A) In general.—Except as provided in subparagraph (B), subsections (a)(6) and (b)(3) of section 408 (relating to required distributions) and section 4974 (relating to excise tax on certain accumulations in qualified retirement plans) shall not apply to any AD IRA.

"(B) Post-death distributions.—Rules similar to the rules of section 401(a)(9) (other than subparagraph (A) thereof) shall apply for purposes of this section.

"(5) Rules relating to rollover contributions.—

"(A) In general.—No rollover contribution may be made to an AD IRA unless it is a qualified rollover contribution.

"(B) Coordination with limit.—A qualified rollover contribution shall not be taken into account for purposes of paragraph (2).

"(6) Time when contributions made.—For purposes of this section, the rule of section 219(f)(3) shall apply.

"(d) Distribution Rules.—For purposes of this title—

"(1) General rules.—

"(A) Exclusions from gross income.—Any qualified distribution from an AD IRA shall not be includible in gross income.

"(B) Nonqualified distributions.—In applying section 72 to any distribution from an AD IRA which is not a qualified distribution, such distribution shall be treated as made from contributions to the AD IRA to the extent that such distribution, when added to all previous distributions from the AD IRA, does not exceed the aggregate amount of contributions to the AD IRA. For purposes of the preceding sentence, all AD IRAs maintained for the benefit of an individual shall be treated as 1 account.

"(C) Exception from penalty tax.—Section 72(t) shall not apply to—

"(i) any qualified distribution from an AD IRA, and

"(ii) any qualified first-time homebuyer distribution (whether or not a qualified distribution) from an AD IRA.

"(2) Qualified distribution.—For purposes of this subsection—

"(A) In general.—The term 'qualified distribution' means any payment or distribution—

"(i) made on or after the date on which the individual attains age 59½,

"(ii) made to a beneficiary (or to the estate of the individual) on or after the death of the individual,

"(iii) attributable to the individual's being disabled (within the meaning of section 72(m)(7)), or

"(iv) which is a qualified first-time homebuyer distribution.

"(B) Distributions within 5 years.—No payment or distribution shall be treated as a qualified distribution if—

"(i) it is made within the 5-taxable year period beginning with the 1st taxable year for which the individual made a contribution to an AD IRA (or such individual's spouse made a contribution to an AD IRA) established for such individual, or

"(ii) in the case of a payment or distribution properly allocable (as determined in the manner prescribed by the Secretary) to a qualified rollover contribution (or income allocable thereto), it is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

Clause (ii) shall not apply to a qualified rollover contribution from an AD IRA.

"(3) ROLLOVERS.—

"(A) IN GENERAL.—Paragraph (1) shall not apply to any distribution which is transferred in a qualified rollover contribution to an AD IRA.

"(B) INCOME INCLUSION FOR ROLLOVERS FROM NON-AD IRAS.—

"(i) IN GENERAL.—In the case of any distribution to which this subparagraph applies—

"(I) sections 72(t) and 408(d)(3) shall not apply (but section 4980A shall apply), and

"(II) any amount required to be included in gross income by reason of this paragraph shall be so included ratably over the 4-taxable year period beginning with the taxable year in which the distribution is made.

"(ii) DISTRIBUTIONS TO WHICH SUBPARAGRAPH APPLIES.—This subparagraph shall apply to a distribution before January 1, 1999, from an individual retirement plan (other than an AD IRA) maintained for the benefit of an individual to an AD IRA maintained for the benefit of such individual if such distribution would be a qualified rollover contribution were such individual retirement plan an AD IRA.

"(iii) CONVERSIONS.—The conversion of an individual retirement plan (other than an AD IRA) to an AD IRA shall be treated for purposes of this subparagraph as a distribution from such plan to such AD IRA.

"(C) ADDITIONAL REPORTING REQUIREMENTS.—The Secretary shall require that trustees of AD IRAs, trustees of individual retirement plans, or both, whichever is appropriate, shall include such additional information in reports required under section 408(i) as is necessary to ensure that amounts required to be included in gross income under subparagraph (B) are so included.

"(4) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTION.—For purposes of this section—

"(A) IN GENERAL.—The term 'qualified first-time homebuyer distribution' means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 60th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

"(B) LIFETIME DOLLAR LIMITATION.—The aggregate amount of payments or distributions received by an individual which may be treated as qualified first-time homebuyer distributions for any taxable year shall not exceed the excess (if any) of—

"(i) $10,000, over

"(ii) the aggregate amounts treated as qualified first-time homebuyer distributions with respect to such individual for all prior taxable years.

"(C) QUALIFIED ACQUISITION COSTS.—For purposes of this paragraph, the term 'qualified acquisition costs' means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

"(D) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.—For purposes of this paragraph—

"(i) FIRST-TIME HOMEBUYER.—The term 'first-time homebuyer' means any individual if—

"(I) such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies, and

"(II) subsection (h) or (k) of section 1034 (as in effect on the day before the date of the enactment of this section) did not suspend the running of any period of time specified in section 1034 (as so in effect) with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

"(ii) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 121.

"(iii) DATE OF ACQUISITION.—The term 'date of acquisition' means the date—

"(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

"(II) on which construction or reconstruction of such a principal residence is commenced.

"(E) SPECIAL RULE WHERE DELAY IN ACQUISITION.—If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in section 408(d)(3)(A)(i) (determined by substituting '120 days' for '60 days' in such section), except that—

"(i) section 408(d)(3)(B) shall not be applied to such contribution, and

"(ii) such amount shall not be taken into account in determining whether section 408(d)(3)(A)(i) applies to any other amount.

"(e) QUALIFIED ROLLOVER CONTRIBUTION.—For purposes of this section, the term 'qualified rollover contribution' means a rollover contribution to an AD IRA from another such account, but only if such rollover contribution meets the requirements of section 408(d)(3)."

(b) REPEAL OF NONDEDUCTIBLE CONTRIBUTIONS.—

(1) Subsection (f) of section 219 is amended by striking paragraph (7).

(2) Paragraph (5) of section 408(d) is amended by striking the last sentence.

(3) Section 408(o) is amended by adding at the end the following new paragraph:

"(5) TERMINATION.—This subsection shall not apply to any designated nondeductible contribution for any taxable year beginning after December 31, 1997."

(4) Subsection (b) of section 4973 is amended by striking the last sentence.

(c) EXCESS DISTRIBUTIONS TAX NOT TO APPLY.—

(1) Subparagraph (A) of section 4980A(d)(3) is amended by inserting "(other than AD IRAs, as defined in section 4980A(b))" after "individual retirement plans".

(2) Subparagraph (B) of section 4980A(e)(1) is amended by inserting "other than an AD IRA (as defined in section 408A(b))" after "retirement plan".

(d) EXCESS CONTRIBUTIONS.—

(1) Section 4973 is amended by adding at the end the following new subsection:

"(f) EXCESS CONTRIBUTIONS TO AMERICAN DREAM IRAS.—For purposes of this section, in the case of American Dream IRAs, the term 'excess contributions' means the amount by which the amount contributed for the taxable year to such IRAs exceeds the limitation in section 408A(c)(2)."

(2) Subsection (b) of section 4973 is amended by adding at the end the following new sentence: "For purposes of this subsection, an American Dream IRA shall not be treated as an individual retirement plan."

(e) CLERICAL AMENDMENT.—The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by inserting after the item relating to section 408 the following new item:

"Sec. 408A. American Dream IRA."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

Subtitle B—Capital Gains

PART I—INDIVIDUAL CAPITAL GAINS

SEC. 311. 20 PERCENT MAXIMUM CAPITAL GAINS RATE FOR INDIVIDUALS.

(a) IN GENERAL.—Subsection (h) of section 1 (relating to maximum capital gains rate) is amended to read as follows:

"(h) MAXIMUM CAPITAL GAINS RATE.—

"(1) IN GENERAL.—If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—

"(A) the base tax amount,

"(B) 10 percent of so much of the taxpayer's adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of—

"(i) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate of 15 percent or less, over

"(ii) the taxable income reduced by the adjusted net capital gain, plus

"(C) 20 percent of the taxpayer's adjusted net capital gain (or, if less, taxable income) in excess of the amount on which a tax is determined under subparagraph (B).

"(2) NET CAPITAL GAIN TAKEN INTO ACCOUNT AS INVESTMENT INCOME.—For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii).

"(3) BASE TAX AMOUNT.—For purposes of paragraph (1), the base tax amount is the lesser of—

"(A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on taxable income reduced by the adjusted net capital gain, or

"(B) the sum of—

"(i) a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—

"(I) taxable income reduced by the net capital gain, or

"(II) the amount of taxable income taxed at a rate below 28 percent,

"(ii) a tax of 26 percent of the lesser of—

"(I) the section 1250 gain, or

"(II) the amount of taxable income in excess of the sum of the amount on which tax is determined under clause (i) plus the net capital gain determined without regard to section 1250 gain, plus

"(iii) a tax of 28 percent of the amount of taxable income in excess of the sum of—

"(I) the adjusted net capital gain, plus

"(II) the sum of the amounts on which tax is determined under clauses (i) and (ii).

"(4) ADJUSTED NET CAPITAL GAIN.—For purposes of this subsection, the term 'adjusted net capital gain' means net capital gain determined without regard to—

"(A) collectibles gain,

"(B) section 1202 gain, and

"(C) section 1250 gain.

"(5) COLLECTIBLES GAIN.—For purposes of paragraph (4)—

"(A) IN GENERAL.—The term 'collectibles gain' means gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income.

"(B) COORDINATION WITH SECTION 1022.—Gain from the disposition of a collectible which is an indexed asset to which section 1022(a) applies shall be disregarded for purposes of this subsection. A taxpayer may elect to treat any collectible specified in such election as not being an indexed asset for purposes of section 1022. Any such election, and any specification therein, once made, shall be irrevocable.

"(C) PARTNERSHIPS, ETC.—For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to the rules of section 751 shall apply for purposes of the preceding sentence.

"(6) SECTION 1202 GAIN.—For purposes of paragraph (4), the term 'section 1202 gain' means gain from the sale or exchange of any qualified small business stock (as defined in section 1202(c)) held more than 5 years which is taken into account in computing gross income.

"(7) SECTION 1250 GAIN.—For purposes of paragraph (4), the term 'section 1250 gain' means the excess (if any) of—

"(A) the amount which would be treated as ordinary income under section 1245 if all section 1250 property disposed of by the taxpayer were section 1245 property, over

"(B) the amount treated as ordinary income under section 1250.

In the case of a taxable year which includes May 7, 1997, section 1250 gain shall be determined by taking into account only the gain properly taken into account for the portion of the taxable year after May 6, 1997.

"(8) PRE-EFFECTIVE DATE GAIN.—

"(A) IN GENERAL.—In the case of a taxable year which includes May 7, 1997, adjusted net capital gain shall be determined without regard to pre-May 7, 1997, gain.

"(B) PRE-MAY 7, 1997, GAIN.—The term 'pre-May 7, 1997, gain' means the amount which would be adjusted net capital gain for the taxable year if adjusted net capital gain were determined by taking into account only the gain or loss properly taken into account for the portion of the taxable year before May 7, 1997.

"(C) SPECIAL RULES FOR PASS-THRU ENTITIES.—In applying subparagraph (A) with respect to any pass-thru entity, the determination of when gains and loss are properly taken into account shall be made at the entity level.

"(D) PASS-THRU ENTITY DEFINED.—For purposes of subparagraph (C), the term 'pass-thru entity' means—

"(i) a regulated investment company,

"(ii) a real estate investment trust,

"(iii) an S corporation,

"(iv) a partnership,

"(v) an estate or trust, and

"(vi) a common trust fund."

(b) MINIMUM TAX.—

(1) IN GENERAL.—Subsection (b) of section 55 is amended by adding at the end the following new paragraph:

"(3) MAXIMUM RATE OF TAX ON NET CAPITAL GAIN OF NONCORPORATE TAXPAYERS.—The amount determined under the first sentence of paragraph (1)(A)(i) shall not exceed the sum of—

"(A) the lesser of—

"(i) the amount determined under such first sentence computed at the rates and in the same manner as if this paragraph had not been enacted on the taxable excess reduced by the adjusted net capital gain (as defined in section 1(h)(4)), or

"(ii) the sum of—

"(I) the amount determined under such first sentence computed at the rates and in the same manner as if this paragraph had not been enacted on the taxable excess reduced by the sum of the adjusted net capital gain (as so defined) and the section 1250 gain (as defined in section 1(h)(7)), plus

"(II) 26 percent of the lesser of the section 1250 gain (as so defined) or the taxable excess reduced by the adjusted net capital gain (as so defined),

"(B) a tax of 10 percent of so much of the taxpayer's adjusted net capital gain (or, if less, taxable excess) as does not exceed the amount on which a tax is determined under section 1(h)(1)(B), plus

"(C) a tax of 20 percent of the taxpayer's adjusted net capital gain (or, if less, taxable excess) in excess of the amount on which tax is determined under subparagraph (B)."

(2) CONFORMING AMENDMENT.—Clause (ii) of section 55(b)(1)(A) is amended by striking "clause (i)" and inserting "this subsection".

(c) OTHER CONFORMING AMENDMENTS.—

(1) Subsection (d) of section 291 is amended by inserting at the end the following new sentence: "Any capital gain dividend treated as having been paid out of such difference to a shareholder which is not a corporation retains its characters as section 1250 gain for purposes of applying section 1(h) to such shareholder."

(2) Paragraph (1) of section 1445(e) is amended by striking "28 percent" and inserting "20 percent".

(3) The second sentence of section 7518(g)(6)(A), and the second sentence of section 607(h)(6)(A) of the Merchant Marine Act, 1936, are each amended by striking "28 percent" and inserting "20 percent".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years ending after May 6, 1997.

(2) WITHHOLDING.—The amendment made by subsection (c)(2) shall apply only to amounts paid after the date of the enactment of this Act.

(3) APPLICATION OF ESTIMATED TAX RULES.—Clause (i) of section 6654(d)(1)(C) of the Internal Revenue Code of 1986 shall be applied by substituting "109 percent" for "110 percent" where the preceding taxable year referred in such clause is a taxable year beginning in calendar year 1996.

SEC. 312. INDEXING OF CERTAIN ASSETS ACQUIRED AFTER DECEMBER 31, 2000, FOR PURPOSES OF DETERMINING GAIN.

(a) IN GENERAL.—Part II of subchapter O of chapter 1 (relating to basis rules of general application) is amended by inserting after section 1021 the following new section:

"SEC. 1022. INDEXING OF CERTAIN ASSETS ACQUIRED AFTER DECEMBER 31, 2000, FOR PURPOSES OF DETERMINING GAIN.

"(a) GENERAL RULE.—

"(1) INDEXED BASIS SUBSTITUTED FOR ADJUSTED BASIS.—Solely for purposes of determining gain on the sale or other disposition by a taxpayer (other than a corporation) of an indexed asset which has been held for more than 3 years, the indexed basis of the asset shall be substituted for its adjusted basis.

"(2) EXCEPTION FOR DEPRECIATION, ETC.—The deductions for depreciation, depletion, and amortization shall be determined without regard to the application of paragraph (1) to the taxpayer or any other person.

"(3) EXCEPTION FOR PRINCIPAL RESIDENCES.—Paragraph (1) shall not apply to any disposition of the principal residence (within the meaning of section 121) of the taxpayer .

"(b) INDEXED ASSET.—

"(1) IN GENERAL.—For purposes of this section, the term 'indexed asset' means—

"(A) common stock in a C corporation (other than a foreign corporation), and

"(B) tangible property,

which is a capital asset or property used in the trade or business (as defined in section 1231(b)).

"(2) STOCK IN CERTAIN FOREIGN CORPORATIONS INCLUDED.—For purposes of this section—

"(A) IN GENERAL.—The term 'indexed asset' includes common stock in a foreign corporation which is regularly traded on an established securities market.

"(B) EXCEPTION.—Subparagraph (A) shall not apply to—

"(i) stock of a foreign investment company (within the meaning of section 1246(b)), "(ii) stock in a passive foreign investment company (as defined in section 1296),

"(iii) stock in a foreign corporation held by a United States person who meets the requirements of section 1248(a)(2), and

"(iv) stock in a foreign personal holding company (as defined in section 552).

"(C) TREATMENT OF AMERICAN DEPOSITORY RECEIPTS.—An American depository receipt for common stock in a foreign corporation shall be treated as common stock in such corporation.

"(c) INDEXED BASIS.—For purposes of this section—

"(1) GENERAL RULE.—The indexed basis for any asset is—

"(A) the adjusted basis of the asset, increased by

"(B) the applicable inflation adjustment.

"(2) APPLICABLE INFLATION ADJUSTMENT.—The applicable inflation adjustment for any asset is an amount equal to—

"(A) the adjusted basis of the asset, multiplied by

"(B) the percentage (if any) by which—

"(i) the chain-type price index for GDP for the last calendar quarter ending before the asset is disposed of, exceeds

"(ii) the chain-type price index for GDP for the last calendar quarter ending before the asset was acquired by the taxpayer.

The percentage under subparagraph (B) shall be rounded to the nearest 1⁄10 of 1 percentage point.

"(3) CHAIN-TYPE PRICE INDEX FOR GDP.—The chain-type price index for GDP for any calendar quarter is such index for such quarter (as shown in the last revision thereof released by the Secretary of Commerce before the close of the following calendar quarter).

"(d) SUSPENSION OF HOLDING PERIOD WHERE DIMINISHED RISK OF LOSS; TREATMENT OF SHORT SALES.—

"(1) IN GENERAL.—If the taxpayer (or a related person) enters into any transaction which substantially reduces the risk of loss from holding any asset, such asset shall not be treated as an indexed asset for the period of such reduced risk.

"(2) SHORT SALES.—

"(A) IN GENERAL.—In the case of a short sale of an indexed asset with a short sale period in excess of 3 years, for purposes of this title, the amount realized shall be an amount equal to the amount realized (determined without regard to this paragraph) increased by the applicable inflation adjustment. In applying subsection (c)(2) for purposes of the preceding sentence, the date on which the property is sold short shall be treated as the date of acquisition and the closing date for the sale shall be treated as the date of disposition.

"(B) SHORT SALE PERIOD.—For purposes of subparagraph (A), the short sale period begins on the day that the property is sold and ends on the closing date for the sale.

"(e) TREATMENT OF REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS.—

"(1) ADJUSTMENTS AT ENTITY LEVEL.—

"(A) IN GENERAL.—Except as otherwise provided in this paragraph, the adjustment under subsection (a) shall be allowed to any qualified investment entity (including for purposes of determining the earnings and profits of such entity).

"(B) EXCEPTION FOR CORPORATE SHAREHOLDERS.—Under regulations—

"(i) in the case of a distribution by a qualified investment entity (directly or indirectly) to a corporation—

"(I) the determination of whether such distribution is a dividend shall be made without regard to this section, and

"(II) the amount treated as gain by reason of the receipt of any capital gain dividend shall be increased by the percentage by which the entity's net capital gain for the taxable year (determined without regard to this section) exceeds the entity's net capital gain for such year determined with regard to this section, and

"(ii) there shall be other appropriate adjustments (including deemed distributions) so as to ensure that the benefits of this section are not allowed (directly or indirectly) to corporate shareholders of qualified investment entities.

For purposes of the preceding sentence, any amount includible in gross income under section 852(b)(3)(D) shall be treated as a capital gain dividend and an S corporation shall not be treated as a corporation.

"(C) EXCEPTION FOR QUALIFICATION PURPOSES.—This section shall not apply for purposes of sections 851(b) and 856(c).

"(D) EXCEPTION FOR CERTAIN TAXES IMPOSED AT ENTITY LEVEL.—

"(i) TAX ON FAILURE TO DISTRIBUTE ENTIRE GAIN.—If any amount is subject to tax under section 852(b)(3)(A) for any taxable year, the amount on which tax is imposed under such section shall be increased by the percentage determined under subparagraph (B)(i)(II). A similar rule shall apply in the case of any amount subject to tax under paragraph (2) or (3) of section 857(b) to the extent attributable to the excess of the net capital gain over the deduction for dividends paid determined with reference to capital gain dividends only. The first sentence of this clause shall not apply to so much of the amount subject to tax under section 852(b)(3)(A) as is designated by the company under section 852(b)(3)(D).

"(ii) OTHER TAXES.—This section shall not apply for purposes of determining the amount of any tax imposed by paragraph (4), (5), or (6) of section 857(b).

"(2) ADJUSTMENTS TO INTERESTS HELD IN ENTITY.—

"(A) REGULATED INVESTMENT COMPANIES.—Stock in a regulated investment company (within the meaning of section 851) shall be an indexed asset for any calendar quarter in the same ratio as—

"(i) the average of the fair market values of the indexed assets held by such company at the close of each month during such quarter, bears to

"(ii) the average of the fair market values of all assets held by such company at the close of each such month.

"(B) REAL ESTATE INVESTMENT TRUSTS.—Stock in a real estate investment trust (within the meaning of section 856) shall be an indexed asset for any calendar quarter in the same ratio as—

"(i) the fair market value of the indexed assets held by such trust at the close of such quarter, bears to

"(ii) the fair market value of all assets held by such trust at the close of such quarter.

"(C) RATIO OF 80 PERCENT OR MORE.—If the ratio for any calendar quarter determined under subparagraph (A) or (B) would (but for this subparagraph) be 80 percent or more, such ratio for such quarter shall be 100 percent.

"(D) RATIO OF 20 PERCENT OR LESS.—If the ratio for any calendar quarter determined under subparagraph (A) or (B) would (but for this subparagraph) be 20 percent or less, such ratio for such quarter shall be zero.

"(E) LOOK-THRU OF PARTNERSHIPS.—For purposes of this paragraph, a qualified investment entity which holds a partnership interest shall be treated (in lieu of holding a partnership interest) as holding its proportionate share of the assets held by the partnership.

"(3) TREATMENT OF RETURN OF CAPITAL DISTRIBUTIONS.—Except as otherwise provided by the Secretary, a distribution with respect to stock in a qualified investment entity which is not a dividend and which results in a reduction in the adjusted basis of such stock shall be treated as allocable to stock acquired by the taxpayer in the order in which such stock was acquired.

"(4) QUALIFIED INVESTMENT ENTITY.—For purposes of this subsection, the term 'qualified investment entity' means—

"(A) a regulated investment company (within the meaning of section 851), and

"(B) a real estate investment trust (within the meaning of section 856).

"(f) OTHER PASS-THRU ENTITIES.—

"(1) PARTNERSHIPS.—

"(A) IN GENERAL.—In the case of a partnership, the adjustment made under subsection (a) at the partnership level shall be passed through to the partners.

"(B) SPECIAL RULE IN THE CASE OF SECTION 754 ELECTIONS.—In the case of a transfer of an interest in a partnership with respect to which the election provided in section 754 is in effect—

"(i) the adjustment under section 743(b)(1) shall, with respect to the transferor partner, be treated as a sale of the partnership assets for purposes of applying this section, and

"(ii) with respect to the transferee partner, the partnership's holding period for purposes of this section in such assets shall be treated as beginning on the date of such adjustment.

"(2) S CORPORATIONS.—In the case of an S corporation, the adjustment made under subsection (a) at the corporate level shall be passed through to the shareholders. This section shall not apply for purposes of determining the amount of any tax imposed by section 1374 or 1375.

"(3) COMMON TRUST FUNDS.—In the case of a common trust fund, the adjustment made under subsection (a) at the trust level shall be passed through to the participants.

"(4) INDEXING ADJUSTMENT DISREGARDED IN DETERMINING LOSS ON SALE OF INTEREST IN ENTITY.—Notwithstanding the preceding provisions of this subsection, for purposes of determining the amount of any loss on a sale or exchange of an interest in a partnership, S corporation, or common trust fund, the adjustment made under subsection (a) shall not be taken into account in determining the adjusted basis of such interest.

"(g) DISPOSITIONS BETWEEN RELATED PERSONS.—

"(1) IN GENERAL.—This section shall not apply to any sale or other disposition of property between related persons except to the extent that the basis of such property in the hands of the transferee is a substituted basis.

"(2) RELATED PERSONS DEFINED.—For purposes of this section, the term 'related persons' means—

"(A) persons bearing a relationship set forth in section 267(b), and

"(B) persons treated as single employer under subsection (b) or (c) of section 414.

"(h) TRANSFERS TO INCREASE INDEXING ADJUSTMENT.—If any person transfers cash, debt, or any other property to another person and the principal purpose of such transfer is to secure or increase an adjustment under subsection (a), the Secretary may disallow part or all of such adjustment or increase.

"(i) SPECIAL RULES.—For purposes of this section—

"(1) TREATMENT OF IMPROVEMENTS, ETC.—If there is an addition to the adjusted basis of any tangible property or of any stock in a corporation during the taxable year by reason of an improvement to such property or a contribution to capital of such corporation—

"(A) such addition shall never be taken into account under subsection (c)(1)(A) if the aggregate amount thereof during the taxable year with respect to such property or stock is less than $1,000, and

"(B) such addition shall be treated as a separate asset acquired at the close of such taxable year if the aggregate amount thereof during the taxable year with respect to such property or stock is $1,000 or more.

A rule similar to the rule of the preceding sentence shall apply to any other portion of an asset to the extent that separate treatment of such portion is appropriate to carry out the purposes of this section.

"(2) ASSETS WHICH ARE NOT INDEXED ASSETS THROUGHOUT HOLDING PERIOD.—The applicable inflation adjustment shall be appropriately reduced for periods during which the asset was not an indexed asset.

"(3) TREATMENT OF CERTAIN DISTRIBUTIONS.—A distribution with respect to stock in a corporation which is not a dividend shall be treated as a disposition.

"(4) ACQUISITION DATE WHERE THERE HAS BEEN PRIOR APPLICATION OF SUBSECTION (a)(1) WITH RESPECT TO THE TAXPAYER.—If there has been a prior application of subsection (a)(1) to an asset while such asset was held by the taxpayer, the date of acquisition of such asset by the taxpayer shall be treated as not earlier than the date of the most recent such prior application.

"(5) COLLAPSIBLE CORPORATIONS.—The application of section 341(a) (relating to collapsible corporations) shall be determined without regard to this section.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) CLERICAL AMENDMENT.—The table of sections for part II of subchapter O of chapter 1 is amended by inserting after the item relating to section 1021 the following new item:

"Sec. 1022. Indexing of certain assets acquired after December 31, 2000, for purposes of determining gain."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to the disposition of any property the holding period of which begins after December 31, 2000.

(2) CERTAIN TRANSACTIONS BETWEEN RELATED PERSONS.—The amendments made by this section shall not apply to the disposition of any property acquired after December 31, 2000, from a related person (as defined in section 1022(g)(2) of the Internal Revenue Code of 1986, as added by this section) if—

(A) such property was so acquired for a price less than the property's fair market value, and

(B) the amendments made by this section did not apply to such property in the hands of such related person.

(d) ELECTION TO RECOGNIZE GAIN ON ASSETS HELD ON JANUARY 1, 2001.—For purposes of the Internal Revenue Code of 1986—

(1) IN GENERAL.—A taxpayer other than a corporation may elect to treat—

(A) any readily tradable stock (which is an indexed asset) held by such taxpayer on January 1, 2001, and not sold before the next business day after such date, as having been sold on such next business day for an amount equal to its closing market price on such next business day (and as having been reacquired on such next business day for an amount equal to such closing market price), and

(B) any other indexed asset held by the taxpayer on January 1, 2001, as having been sold on such date for an amount equal to its fair market value on such date (and as having been reacquired on such date for an amount equal to such fair market value).

(2) TREATMENT OF GAIN OR LOSS.—

(A) Any gain resulting from an election under paragraph (1) shall be treated as received or accrued on the date the asset is treated as sold under paragraph (1) and shall be recognized notwithstanding any provision of the Internal Revenue Code of 1986.

(B) Any loss resulting from an election under paragraph (1) shall not be allowed for any taxable year.

(3) ELECTION.—An election under paragraph (1) shall be made in such manner as the Secretary of the Treasury or his delegate may prescribe and shall specify the assets for which such election is made. Such an election, once made with respect to any asset, shall be irrevocable.

(4) READILY TRADABLE STOCK.—For purposes of this subsection, the term "readily tradable stock" means any stock which, as of January 1, 2001, is readily tradable on an established securities market or otherwise.

SEC. 313. EXEMPTION FROM TAX FOR GAIN ON SALE OF PRINCIPAL RESIDENCE.

(a) IN GENERAL.—Section 121 (relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55) is amended to read as follows:

"SEC. 121. EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE.

"(a) EXCLUSION.—Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

"(b) LIMITATIONS.—

"(1) DOLLAR LIMITATION.—The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000 ($500,000 in the case of a joint return where both spouses meet the use requirement of subsection (a)).

"(2) APPLICATION TO ONLY 1 SALE OR EXCHANGE EVERY 2 YEARS.—

"(A) IN GENERAL.—Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer or his spouse to which subsection (a) applied.

"(B) PREMARRIAGE SALES BY SPOUSE NOT TAKEN INTO ACCOUNT.—If, but for this subparagraph, subsection (a) would not apply to a sale or exchange by a married individual by reason of a sale or exchange by such individual's spouse before their marriage—

"(i) subparagraph (A) shall be applied without regard to the sale or exchange by such individual's spouse, but

"(ii) the amount of gain excluded from gross income under subsection (a) with respect to the sale or exchange by such individual shall not exceed $250,000.

"(C) PRE-MAY 7, 1997, SALES NOT TAKEN INTO ACCOUNT.—Subparagraph (A) shall be applied without regard to any sale or exchange before May 7, 1997.

"(c) EXCLUSION FOR TAXPAYERS FAILING TO MEET CERTAIN REQUIREMENTS.—

"(1) IN GENERAL.—In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a) shall not apply and subsection (b)(2) shall not apply; but the amount of gain excluded from gross income under subsection (a) with respect to such sale of exchange shall not exceed—

"(A) the amount which bears the same ratio to the amount which would be so excluded if such requirements had been met, as

"(B) the shorter of—

"(i) the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence, or

"(ii) the period after the date of the most recent prior sale or exchange by the taxpayer or his spouse to which subsection (a) applied and before the date of such sale or exchange,

bears to 2 years.

"(2) SALES AND EXCHANGES TO WHICH SUBSECTION APPLIES.—This subsection shall apply to any sale or exchange if—

"(A) subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of—

"(i) a failure to meet the ownership and use requirements of subsection (a), or

"(ii) subsection (b)(2), and

"(B) such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, other unforeseen circumstances.

"(d) SPECIAL RULES.—

"(1) JOINT RETURNS.—For purposes of this section, if a husband and wife make a joint return for the taxable year of the sale or exchange of the property, subsection (a) shall, subject to the provisions of subsection (b), apply if either spouse meets the ownership and use requirements of subsection (a) with respect to such property.

"(2) PROPERTY OF DECEASED SPOUSE.—For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period such unmarried individual owned such property shall include the period such deceased spouse held such property before death.

"(3) PROPERTY OF DIVORCED SPOUSE.—For purposes of this section, in the case of an individual holding property transferred to such individual incident to divorce (within the meaning of section 1041(c))—

"(A) the period such individual owns such property shall include the period the former spouse owned the property, and

"(B) the dollar limitation applicable under paragraph (1) shall not be less than the amount such limitation would have been had the sale or exchange occurred on the date the divorce became final.

"(4) TENANT-STOCKHOLDER IN COOPERATIVE HOUSING CORPORATION.—For purposes of this section, if the taxpayer holds stock as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as defined in such section), then—

"(A) the holding requirements of subsection (a) shall be applied to the holding of such stock, and

"(B) the use requirements of subsection (a) shall be applied to the house or apartment which the taxpayer was entitled to occupy as such stockholder.

"(5) INVOLUNTARY CONVERSIONS.—

"(A) IN GENERAL.—For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

"(B) APPLICATION OF SECTION 1033.—In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to this section.

"(C) PROPERTY ACQUIRED AFTER INVOLUNTARY CONVERSION.—If the basis of the property sold or exchanged is determined (in whole or in part) under section 1033(b) (relating to basis of property acquired through involuntary conversion), then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

"(6) RECOGNITION OF GAIN ATTRIBUTABLE TO DEPRECIATION.—Subsection (a) shall not apply to so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to periods after May 6, 1997, in respect of such property.

"(7) DETERMINATION OF USE DURING PERIODS OF OUT-OF-RESIDENCE CARE.—In the case of a taxpayer who—

"(A) becomes physically or mentally incapable of self-care, and

"(B) owns property and uses such property as the taxpayer's principal residence during the 5-year period described in subsection (a) for periods aggregating at least 1 year,

then the taxpayer shall be treated as using such property as the taxpayer's principal residence during any time during such

5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

"(8) DETERMINATION OF MARITAL STATUS.—In the case of any sale or exchange, for purposes of this section—

"(A) the determination of whether an individual is married shall be made as of the date of the sale or exchange, and

"(B) an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

"(9) SALES OF LIFE ESTATES AND REMAINDER INTERESTS.—For purposes of this section—

"(A) IN GENERAL.—This section shall not fail to apply to the sale or exchange of an interest in a principal residence by reason of such interest being a life estate or a remainder interest in such residence, but this section shall apply only to one such interest in such residence which is sold or exchanged separately.

"(B) EXCEPTION FOR SALES TO RELATED PARTIES.—Subparagraph (A) shall not apply to any sale to, or exchange with, any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b).

"(e) DENIAL OF EXCLUSION FOR EXPATRIATES.—This section shall not apply to any sale or exchange by an individual if the treatment provided by section 877(a)(1) applies to such individual.

"(f) ELECTION TO HAVE SECTION NOT APPLY.—This section shall not apply to any sale or exchange with respect to which the taxpayer elects not to have this section apply.

"(g) RESIDENCES ACQUIRED IN ROLLOVERS UNDER SECTION 1034.—For purposes of this section, in the case of property the acquisition of which by the taxpayer resulted under section 1034 (as in effect on the day before the date of the enactment of this sentence) in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, in determining the period for which the taxpayer has owned and used such property as the taxpayer's principal residence, there shall be included the aggregate periods for which such other residence (and each prior residence taken into account under section 1223(7) in determining the holding period of such property) had been so owned and used."

(b) REPEAL OF NONRECOGNITION OF GAIN ON ROLLOVER OF PRINCIPAL RESIDENCE.—Section 1034 (relating to rollover of gain on sale of principal residence) is hereby repealed.

(c) CONFORMING AMENDMENTS.—

(1) The following provisions of the Internal Revenue Code of 1986 are each amended by striking "section 1034" and inserting "section 121": sections 25(e)(7), 56(e)(1)(A), 56(e)(3)(B)(i), 143(i)(1)(C)(i)(I), 163(h)(4)(A)(i)(I), 280A(d)(4)(A), 464(f)(3)(B)(i), 1033(h)(4), 1274(c)(3)(B), 6334(a)(13), and 7872(f)(11)(A).

(2) Paragraph (4) of section 32(c) is amended by striking "(as defined in section 1034(h)(3))" and by adding at the end the following new sentence: "For purposes of the preceding sentence, the term 'extended active duty' means any period of active duty

pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period."

(3) Subparagraph (A) of 143(m)(6) is amended by inserting "(as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1997)" after "1034(e)".

(4) Subsection (e) of section 216 is amended by striking "such exchange qualifies for nonrecognition of gain under section 1034(f)" and inserting "such dwelling unit is used as his principal residence (within the meaning of section 121)".

(5) Section 512(a)(3)(D) is amended by inserting "(as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1997)" after "1034".

(6) Paragraph (7) of section 1016(a) is amended by inserting "(as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1997)" after "1034" and by inserting "(as so in effect)" after "1034(e)".

(7) Paragraph (3) of section 1033(k) is amended to read as follows:

"(3) For exclusion from gross income of gain from involuntary conversion of principal residence, see section 121."

(8) Subsection (e) of section 1038 is amended to read as follows:

"(e) PRINCIPAL RESIDENCES.—If—

"(1) subsection (a) applies to a reacquisition of real property with respect to the sale of which gain was not recognized under section 121 (relating to gain on sale of principal residence); and

"(2) within 1 year after the date of the reacquisition of such property by the seller, such property is resold by him,

then, under regulations prescribed by the Secretary, subsections (b), (c), and (d) of this section shall not apply to the reacquisition of such property and, for purposes of applying section 121, the resale of such property shall be treated as a part of the transaction constituting the original sale of such property."

(9) Paragraph (7) of section 1223 is amended by inserting "(as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1997)" after "1034".

(10) Paragraph (7) of section 1250(d) is amended to read as follows:

"(7) DISPOSITION OF PRINCIPAL RESIDENCE.—Subsection (a) shall not apply to a disposition of property to the extent used by the taxpayer as his principal residence (within the meaning of section 121, relating to gain on sale of principal residence)."

(11) Subsection (c) of section 6012 is amended by striking "(relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55)" and inserting "(relating to gain from sale of principal residence)".

(12) Paragraph (2) of section 6212(c) is amended by striking subparagraph (C) and by redesignating the succeeding subparagraphs accordingly.

(13) Section 6504 is amended by striking paragraph (4) and by redesignating the succeeding paragraphs accordingly.

(14) The item relating to section 121 in the table of sections for part III of subchapter B of chapter 1 is amended to read as follows:

"Sec. 121. Exclusion of gain from sale of principal residence."

(15) The table of sections for part III of subchapter O of chapter 1 of such Code is amended by striking the item relating to section 1034.

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to sales and exchanges after May 6, 1997.

(2) SALES BEFORE DATE OF ENACTMENT.—At the election of the taxpayer, the amendments made by this section shall not apply to any sale or exchange before the date of the enactment of this Act.

(3) BINDING CONTRACTS.—At the election of the taxpayer, the amendments made by this section shall not apply to a sale or exchange after the date of the enactment of this Act, if—

(A) such sale or exchange is pursuant to a contract which was binding on such date, or

(B) without regard to such amendments, gain would not be recognized under section 1034 of the Internal Revenue Code of 1986 (as in effect on the day before the date of the enactment of this Act) on such sale or exchange by reason of a new residence acquired on or before such date or with respect to the acquisition of which by the taxpayer a binding contract was in effect on such date.

This paragraph shall not apply to any sale or exchange by an individual if the treatment provided by section 877(a)(1) of the Internal Revenue Code of 1986 applies to such individual.

PART II—CORPORATE CAPITAL GAINS

SEC. 321. REDUCTION OF ALTERNATIVE CAPITAL GAIN TAX FOR CORPORATIONS.

(a) IN GENERAL.—Section 1201 is amended to read as follows:

"SEC. 1201. ALTERNATIVE TAX FOR CORPORATIONS.

"(a) GENERAL RULE.—If for any taxable year a corporation has 8-year gain, then, in lieu of the tax imposed by sections 11, 511, and 831 (a) and (b) (whichever is applicable), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

"(1) a tax computed on the taxable income reduced by the amount of the 8-year gain, at the rates and in the manner as if this subsection had not been enacted, plus

"(2) a tax of the applicable percentage of the amount of the 8-year gain (or, if less, taxable income).

"(b) APPLICABLE PERCENTAGE.—For purposes of subsection (a)—

"(1) IN GENERAL.—The term 'applicable percentage' means—

"(A) 32 percent for the portion of any taxable year within 1998,

"(B) 31 percent for the portion of any taxable year within 1999, and

"(C) 30 percent for the portion of any taxable year after 1999.

"(2) FISCAL YEAR TAXPAYERS.—

"(A) TAXABLE YEARS BEGINNING IN 1997.—In applying this section to taxable years beginning in 1997, 8-year gain shall not exceed the 8-year gain determined by taking into account only gains and losses properly taken into account for the portion of the taxable year after December 31, 1997.

"(B) TAXABLE YEARS BEGINNING IN 1998 OR 1999.—In the case of a taxable year beginning in 1998 or 1999 which includes portions of 2 calendar years, the applicable percentage shall be applied separately to such portions by taking into account—

"(i) in the case of the first such portion, the lesser of—

"(I) the 8-year gain determined by taking into account only gains and losses properly taken into account for such portion, or

"(II) the 8-year gain determined for the entire taxable year, and

"(ii) in the case of the second such portion, the 8-year gain (and the taxable income) determined for the entire taxable year reduced by the amount on which tax is determined under subsection (a)(2) for the first such portion determined under clause (i).

"(C) SPECIAL RULE FOR PASS-THRU ENTITIES.—Section 1(h)(8)(C) shall apply for purposes of this paragraph.

"(c) 8-YEAR GAIN.—For purposes of this section, the term '8-year gain' means the lesser of—

"(1) the amount of long-term capital gain which would be computed for the taxable year if only gain from the sale or exchange of property held by the taxpayer for more than 8 years were taken into account, or

"(2) net capital gain.

The determination under the preceding sentence shall be made without regard to collectibles gain (as defined in section 1(h)(5)) or section 1250 gain (as defined in section 1(h)(7)).

"(d) CROSS REFERENCES.—

"For computation of the alternative tax—

"(1) in the case of life insurance companies, see section 801(a)(2),

"(2) in the case of regulated investment companies and their shareholders, see section 852(b)(3)(A) and (D), and

"(3) in the case of real estate investment trusts, see section 857(b)(3)(A)."

(b) TECHNICAL AMENDMENTS.—

(1) Subsection (d) of section 291 is amended by striking "subsection (a)(1) to such shareholder" and inserting "subsection (a)(1) and section 1201 to such shareholder".

(2) Clause (iii) of section 852(b)(3)(D) is amended by striking "65 percent" and inserting "the applicable percentage" and by inserting at the end the following new sentence: "For purposes of the preceding sentence, the term 'applicable percentage'

means the percentage equal to the excess of 100 percent over the percentage applicable under section 1201(a).”

(3)(A) Subparagraph (B) of section 852(b)(3) is amended to read as follows:

“(B) TREATMENT OF CAPITAL GAIN DIVIDENDS BY SHAREHOLDERS.—

“(i) IN GENERAL.—Except as provided in clause (ii), a capital gain dividend shall be treated by the shareholders as gain from the sale or exchange of a capital asset held for more than 1 year.

“(ii) COORDINATION WITH 8-YEAR HOLDING PERIOD FOR CORPORATE NET CAPITAL GAIN.—The portion of any capital gain dividend designated by the company as allocable to gain from the sale or exchange of property held by the company for more than 8 years shall be treated as gain from the sale or exchange of a capital asset held for more than 8 years. Rules similar to the rules of subparagraph (C) shall apply to any designation under the preceding sentence.”

(B) Clause (i) of section 851(b)(3)(D) is amended by adding at the end thereof the following new sentence: “Rules similar to the rules of subparagraph (B) shall apply in determining character of the amount to be so included by any such shareholder which is a corporation.”

(4) Subparagraph (B) of section 857(b)(3) is amended to read as follows:

“(B) TREATMENT OF CAPITAL GAIN DIVIDENDS BY SHAREHOLDERS.—

“(i) IN GENERAL.—Except as provided in clause (ii), a capital gain dividend shall be treated by the shareholders or holders of beneficial interests as gain from the sale or exchange of a capital asset held for more than 1 year.

“(ii) COORDINATION WITH 8-YEAR HOLDING PERIOD FOR CORPORATE NET CAPITAL GAIN.—The portion of any capital gain dividend designated by the company as allocable to gain from the sale or exchange of property held by the company for more than 8 years shall be treated as gain from the sale or exchange of a capital asset held for more than 8 years. Rules similar to the rules of subparagraph (C) shall apply to any designation under the preceding sentence.”

(5) Subsection (c) of section 584 is amended—

(A) by inserting “but not more than 8 years” after “1 year” each place it appears in paragraph (2),

(B) by striking “and” at the end of paragraph (2), and

(C) by redesignating paragraph (3) as paragraph (4) and inserting after paragraph (2) the following new paragraph:

“(3) as part of its gains and losses from sales or exchanges of capital assets held for more than 8 years, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 8 years, and”.

(6) Subparagraph (E) of section 904(b)(3) is amended by adding at the end the following new clause:

"(iv) REGULATIONS.—The Secretary shall prescribe regulations that adjust the limitation under subsection (a) to reflect the rate differential for 8-year gain (as defined in section 1201(c)) between the highest rate of tax specified in section 11(b) and the alternate rate of tax under section 1201(a) and the limitation on the deduction for capital losses under section 1211."

(c) EFFECTIVE DATES.—The amendments made by this section shall apply to taxable years ending after December 31, 1997.

TITLE IV—ALTERNATIVE MINIMUM TAX REFORM

SEC. 401. ADJUSTMENT OF EXEMPTION AMOUNTS FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) IN GENERAL.—Subsection (d) of section 55 is amended by adding at the end the following new paragraph:

"(4) ADJUSTMENT OF EXEMPTION AMOUNTS FOR TAXPAYERS OTHER THAN CORPORATIONS.—

"(A) TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 2008.—In the case of any taxable year beginning in a calendar year after 1998 and before 2008—

"(i) IN GENERAL.—The dollar amount applicable under paragraph (1)(A) for any odd-numbered calendar year—

"(I) shall be $1,000 greater than the dollar amount applicable under paragraph (1)(A) for the prior odd-numbered calendar year, and

"(II) shall apply to taxable years beginning in such odd-numbered calendar year and the succeeding calendar year.

"(B) TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 2007.—In the case of any taxable year beginning in a calendar year after 2007, the dollar amount applicable under paragraph (1)(A) for taxable years beginning in 2007 shall be increased by an amount equal to the product of—

"(i) such dollar amount, and

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2006' for 'calendar year 1992' in subparagraph (B) thereof.

If any increase determined under the preceding sentence is not a multiple of $100, such increase shall be rounded to the next lowest multiple of $100.

"(C) OTHER AMOUNTS.—

"(i) The dollar amount applicable under paragraph (1)(B) for any taxable year shall be an amount equal to 75 percent of the dollar amount applicable under paragraph (1)(A) for such year.

"(ii) The dollar amount applicable under paragraph (1)(C) for any taxable year shall be an amount equal to 50 percent of the dollar amount applicable under paragraph (1)(A) for such year."

(b) CONFORMING AMENDMENT.—The last sentence of section 55(d)(3) is amended by striking "$165,000 or (ii) $22,500" and inserting "the minimum amount of such income (as so determined) for which the exemption amount under paragraph (1)(C) is zero, or (ii) such exemption amount (determined without regard to this paragraph)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1998.

SEC. 402. EXEMPTION FROM ALTERNATIVE MINIMUM TAX FOR SMALL CORPORATIONS.

(a) IN GENERAL.—Section 55 (relating to alternative minimum tax imposed) is amended by adding at the end the following new subsection:

"(e) EXEMPTION FOR SMALL CORPORATIONS.—

"(1) IN GENERAL.—The tentative minimum tax of a corporation shall be zero for any taxable year if—

"(A) such corporation met the $5,000,000 gross receipts test of section 448(c) for any prior taxable year beginning after December 31, 1996, and

"(B) such corporation would meet such test for the taxable year and all prior taxable years beginning after December 31, 1997, if such test were applied by substituting '$7,500,000' for '$5,000,000'.

"(2) PROSPECTIVE APPLICATION OF MINIMUM TAX IF SMALL CORPORATION CEASES TO BE SMALL.—In the case of a corporation whose tentative minimum tax is zero for any prior taxable year by reason of paragraph (1), the application of this part for taxable years beginning with the first taxable year such corporation ceases to be described in paragraph (1) shall be determined without regard to transactions entered into or other items arising in taxable years prior to such first taxable year.

"(3) LIMITATION ON USE OF CREDIT FOR PRIOR YEAR MINIMUM TAX LIABILITY.—In the case of a taxpayer whose tentative minimum tax for any taxable year is zero by reason of paragraph (1), the amount described in paragraph (2) of section 53(b) shall not be less than the greater of—

"(A) the tentative minimum tax for the taxable year, or

"(B) 25 percent of so much of the regular tax liability (reduced by the credit allowed by section 27) as exceeds $25,000.

Rules similar to the rules of section 38(c)(3)(B) shall apply for purposes of the preceding sentence."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 403. REPEAL OF ADJUSTMENT FOR DEPRECIATION.

Clause (i) of section 56(a)(1)(A) is amended by inserting "and before January 1, 1999," after "December 31, 1986,".

SEC. 404. MINIMUM TAX NOT TO APPLY TO FARMERS' INSTALLMENT SALES.

(a) IN GENERAL.—The last sentence of paragraph (6) of section 56(a) (relating to treatment of installment sales in computing alternative minimum taxable income) is amended to read as follows: "This paragraph shall not apply to any disposition—

"(A) in the case of a taxpayer using the cash receipts and disbursements method of accounting, described in section 453(l)(2)(A) (relating to farm property), or

"(B) with respect to which an election is in effect under section 453(l)(2)(B) (relating to timeshares and residential lots)."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by this section shall apply to dispositions in taxable years beginning after December 31, 1987.

(2) SPECIAL RULE FOR 1987.—In the case of taxable years beginning in 1987, the last sentence of section 56(a)(6) of the Internal Revenue Code of 1986 (as in effect for such taxable years) shall be applied by inserting "or in the case of a taxpayer using the cash receipts and disbursements method of accounting, any disposition described in section 453C(e)(1)(B)(ii)" after "section 453C(e)(4)".

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

Subtitle A—Estate and Gift Tax Provisions

SEC. 501. COST-OF-LIVING ADJUSTMENTS RELATING TO ESTATE AND GIFT TAX PROVISIONS.

(a) INCREASE IN UNIFIED ESTATE AND GIFT TAX CREDIT.—

(1) ESTATE TAX CREDIT.—

(A) IN GENERAL.—Subsection (a) of section 2010 (relating to unified credit against estate tax) is amended by striking "$192,800" and inserting "the applicable credit amount".

(B) APPLICABLE CREDIT AMOUNT.—Section 2010 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) APPLICABLE CREDIT AMOUNT.—For purposes of this section—

"(1) IN GENERAL.—For purposes of this section, the applicable credit amount is the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount determined in accordance with the following table:

"In the case of estates of decedents dying, and gifts made, during:	The applicable exclusion amount is:
1998	$ 650,000
1999	$ 750,000
2000	$ 765,000
2001 through 2004	$ 775,000
2005	$ 800,000

2006	$ 825,000
2007 or thereafter	$1,000,000.

"(2) COST-OF-LIVING ADJUSTMENT.—In the case of any decedent dying, and gift made, in a calendar year after 2007, the $1,000,000 amount set forth in paragraph (1) shall be increased by an amount equal to—

"(A) $1,000,000, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2006' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the next lowest multiple of $10,000."

(C) ESTATE TAX RETURNS.—Paragraph (1) of section 6018(a) is amended by striking "$600,000" and inserting "the applicable exclusion amount in effect under section 2010(c) for the calendar year which includes the date of death".

(D) PHASEOUT OF GRADUATED RATES AND UNIFIED CREDIT.—Paragraph (2) of section 2001(c) is amended by striking "$21,040,000" and inserting "the amount at which the average tax rate under this section is 55 percent".

(E) ESTATES OF NONRESIDENTS NOT CITIZENS.—Subparagraph (A) of section 2102(c)(3) is amended by striking "$192,800" and inserting "the applicable credit amount in effect under section 2010(c) for the calendar year which includes the date of death".

(2) UNIFIED GIFT TAX CREDIT.—Paragraph (1) of section 2505(a) is amended by striking "$192,800" and inserting "the applicable credit amount in effect under section 2010(c) for such calendar year".

(b) ALTERNATE VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY.—Subsection (a) of section 2032A is amended by adding at the end the following new paragraph:

"(3) INFLATION ADJUSTMENT.—In the case of estates of decedents dying in a calendar year after 1998, the $750,000 amount contained in paragraph (2) shall be increased by an amount equal to—

"(A) $750,000, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the next lowest multiple of $10,000."

(c) ANNUAL GIFT TAX EXCLUSION.—Subsection (b) of section 2503 is amended—

(1) by striking the subsection heading and inserting the following:

"(b) EXCLUSIONS FROM GIFTS.—

"(1) IN GENERAL.—",

(2) by moving the text 2 ems to the right, and

(3) by adding at the end the following new paragraph:

"(2) INFLATION ADJUSTMENT.—In the case of gifts made in a calendar year after 1998, the $10,000 amount contained in paragraph (1) shall be increased by an amount equal to—

"(A) $10,000, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $1,000, such amount shall be rounded to the next lowest multiple of $1,000."

(d) EXEMPTION FROM GENERATION-SKIPPING TAX.—Section 2631 (relating to GST exemption) is amended by adding at the end the following new subsection:

"(c) INFLATION ADJUSTMENT.—In the case of an individual who dies in any calendar year after 1998, the $1,000,000 amount contained in subsection (a) shall be increased by an amount equal to—

"(1) $1,000,000, multiplied by

"(2) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the next lowest multiple of $10,000."

(e) AMOUNT SUBJECT TO REDUCED RATE WHERE EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX ON CLOSELY HELD BUSINESS.—Subsection (j) of section 6601 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) INFLATION ADJUSTMENT.—In the case of estates of decedents dying in a calendar year after 1998, the $1,000,000 amount contained in paragraph (2)(A) shall be increased by an amount equal to—

"(A) $1,000,000, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the next lowest multiple of $10,000."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying, and gifts made, after December 31, 1997.

SEC. 502. 20-YEAR INSTALLMENT PAYMENT WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS.

(a) IN GENERAL.—Section 6166(a) (relating to extension of time for payment of estate tax where estate consists largely of interest in closely held business) is amended by striking "10" in paragraph (1) and the heading thereof and inserting "20".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after December 31, 1997.

SEC. 503. NO INTEREST ON CERTAIN PORTION OF ESTATE TAX EXTENDED UNDER SECTION 6166, REDUCED INTEREST ON REMAINING PORTION, AND NO DEDUCTION FOR SUCH REDUCED INTEREST.

(a) NO INTEREST AND REDUCED INTEREST.—

(1) IN GENERAL.—Paragraphs (1) and (2) of section 6601(j) (relating to 4-percent rate on certain portion of estate tax extended under section 6166), as amended by section 501(e), are amended to read as follows:

"(1) IN GENERAL.—If the time for payment of an amount of tax imposed by chapter 11 is extended as provided in section 6166, then in lieu of the annual rate provided by subsection (a)—

"(A) no interest shall be paid on the no-interest portion of such amount, and

"(B) interest on so much of such amount as exceeds such no-interest portion shall be paid at a rate equal to 45 percent of the annual rate provided by subsection (a).

For purposes of this subsection, the amount of any deficiency which is prorated to installments payable under section 6166 shall be treated as an amount of tax payable in installments under such section.

"(2) NO-INTEREST PORTION.—For purposes of this section, the term 'no-interest portion' means the lesser of—

"(A)(i) the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of $1,000,000 and the applicable exclusion amount in effect under section 2010(c), reduced by

"(ii) the applicable credit amount in effect under section 2010(c), or

"(B) the amount of the tax imposed by chapter 11 which is extended as provided in section 6166."

(2) CONFORMING AMENDMENTS.—

(A) Section 6601(j), as amended by section 501, is amended—

(i) by striking "4-percent" each place it appears in paragraph (3) and inserting "no-interest", and

(ii) by striking "4-PERCENT RATE ON CERTAIN PORTION OF" in the heading and inserting "RATE ON".

(B) Section 6166(b)(7)(A)(iii) is amended to read as follows:

"(iii) for purposes of applying section 6601(j) (relating to rate on estate tax extended under section 6166), the no-interest portion shall be zero."

(C) Section 6166(b)(8)(A)(iii) is amended to read as follows:

"(iii) NO-INTEREST PORTION NOT TO APPLY.—For purposes of applying section 6601(j) (relating to rate on estate tax extended under section 6166), the no-interest portion shall be zero."

(b) DISALLOWANCE OF INTEREST DEDUCTION.—

(1) ESTATE TAX.—Paragraph (1) of section 2053(c) is amended by adding at the end the following new subparagraph:

"(D) SECTION 6166 INTEREST.—No deduction shall be allowed under this section for any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6166."

(2) INCOME TAX.—Subparagraph (E) of section 163(h)(2) is amended by striking "or 6166".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after December 31, 1997.

SEC. 504. EXTENSION OF TREATMENT OF CERTAIN RENTS UNDER SECTION 2032A TO LINEAL DESCENDANTS.

(a) GENERAL RULE.—Paragraph (7) of section 2032A(c) (relating to special rules for tax treatment of dispositions and failures to use for qualified use) is amended by adding at the end the following new subparagraph:

"(E) CERTAIN RENTS TREATED AS QUALIFIED USE.—For purposes of this subsection, a surviving spouse or lineal descendant of the decedent shall not be treated as failing to use qualified real property in a qualified use solely because such spouse or descendant rents such property to a member of the family of such spouse or descendant on a net cash basis. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood."

(b) CONFORMING AMENDMENT.—Section 2032A(b)(5)(A) is amended by striking the last sentence.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to leases entered into after December 31, 1976.

SEC. 505. CLARIFICATION OF JUDICIAL REVIEW OF ELIGIBILITY FOR EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX.

(a) IN GENERAL.—Part IV of subchapter C of chapter 76 of the Internal Revenue Code of 1986 (relating to declaratory judgments) is amended by adding at the end the following new section:

"SEC. 7479. DECLARATORY JUDGMENTS RELATING TO ELIGIBILITY OF ESTATE WITH RESPECT TO INSTALLMENT PAYMENTS UNDER SECTION 6166.

(a) CREATION OF REMEDY.—In a case of actual controversy involving a determination by the Secretary of (or a failure by the Secretary to make a determination with respect to)—

"(1) whether an election may be made under section 6166 (relating to extension of time for payment of estate tax where estate consists largely of interest in closely held business) with respect to an estate, or

"(2) whether the extension of time for payment of tax provided in section 6166(a) has ceased to apply with respect to an estate,

upon the filing of an appropriate pleading, the Tax Court may make a declaration with respect to whether such election may be made, whether such extension has ceased to apply, or the amount of such installment payments. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(b) LIMITATIONS.—

"(1) PETITIONER.—A pleading may be filed under this section, with respect to any estate, only—

"(A) by the executor of such estate, or

"(B) by any person who has assumed an obligation to make payments under section 6166 with respect to such estate (but only if each other such person is joined as a party).

"(2) EXHAUSTION OF ADMINISTRATIVE REMEDIES.—The court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service. A petitioner shall be deemed to have exhausted its administrative remedies with respect to a failure of the Secretary to make a determination at the expiration of 180 days after the date on which the request for such determination was made if the petitioner has taken, in a timely manner, all reasonable steps to secure such determination.

"(3) TIME FOR BRINGING ACTION.—If the Secretary sends by certified or registered mail notice of his determination as described in subsection (a) to the petitioner, no proceeding may be initiated under this section unless the pleading is filed before the 91st day after the date of such mailing."

(b) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter C of chapter 76 of such Code is amended by adding at the end the following new item:

"Sec. 7479. Declaratory judgments relating to eligibility of estate with respect to installment payments under section 6166."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying after the date of the enactment of this Act.

SEC. 506. GIFTS MAY NOT BE REVALUED FOR ESTATE TAX PURPOSES AFTER EXPIRATION OF STATUTE OF LIMITATIONS.

(a) IN GENERAL.—Section 2001 (relating to imposition and rate of estate tax) is amended by adding at the end the following new subsection:

"(f) VALUATION OF GIFTS.—If—

"(1) the time has expired within which a tax may be assessed under chapter 12 (or under corresponding provisions of prior laws) on the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)), and

"(2) the value of such gift is shown on the return for such preceding calendar period or is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such gift,

the value of such gift shall, for purposes of computing the tax under this chapter, be the value of such gift as finally determined for purposes of chapter 12."

(b) MODIFICATION OF APPLICATION OF STATUTE OF LIMITATIONS.—Paragraph (9) of section 6501(c) is amended to read as follows:

"(9) GIFT TAX ON CERTAIN GIFTS NOT SHOWN ON RETURN.—If any gift of property the value of which (or any increase in taxable gifts required under section 2701(d) which) is required to be shown on a return of tax imposed by chapter 12 (without regard to section 2503(b)), and is not shown on such return, any tax imposed by chapter 12 on such gift may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time. The preceding sentence shall not apply to any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item. The value of any item which is so disclosed may not be redetermined by the Secretary after the expiration of the period under subsection (a).''

(c) DECLARATORY JUDGMENT PROCEDURE FOR DETERMINING VALUE OF GIFT.—

(1) IN GENERAL.—Part IV of subchapter C of chapter 76 is amended by inserting after section 7476 the following new section:

''SEC. 7477. DECLARATORY JUDGMENTS RELATING TO VALUE OF CERTAIN GIFTS.

''(a) CREATION OF REMEDY.—In a case of an actual controversy involving a determination by the Secretary of the value of any gift shown on the return of tax imposed by chapter 12 or disclosed on such return or in any statement attached to such return, upon the filing of an appropriate pleading, the Tax Court may make a declaration of the value of such gift. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

''(b) LIMITATIONS.—

''(1) PETITIONER.—A pleading may be filed under this section only by the donor.

''(2) EXHAUSTION OF ADMINISTRATIVE REMEDIES.—The court shall not issue a declaratory judgment or decree under this section in any proceeding unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service.

''(3) TIME FOR BRINGING ACTION.—If the Secretary sends by certified or registered mail notice of his determination as described in subsection (a) to the petitioner, no proceeding may be initiated under this section unless the pleading is filed before the 91st day after the date of such mailing.''

(2) CLERICAL AMENDMENT.—The table of sections for such part IV is amended by inserting after the item relating to section 7476 the following new item:

''Sec. 7477. Declaratory judgments relating to value of certain gifts.''

(d) CONFORMING AMENDMENT.—Subsection (c) of section 2504 is amended by striking '', and if a tax under this chapter or under corresponding provisions of prior laws has been assessed or paid for such preceding calendar period''.

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsections (a) and (c) shall apply to gifts made after the date of the enactment of this Act.

(2) SUBSECTION (b)—The amendment made by subsection (b) shall apply to gifts made in calendar years ending after the date of the enactment of this Act.

SEC. 507. TERMINATION OF THROWBACK RULES FOR DOMESTIC TRUSTS.

(a) ACCUMULATION DISTRIBUTIONS.—

(1) IN GENERAL.—Section 665 is amended by adding at the end the following new subsection:

"(f) SPECIAL RULE FOR UNITED STATES TRUSTS.—For purposes of this subpart, in the case of a trust other than a foreign trust, any distribution in any taxable year beginning after the date of the enactment of this subsection shall be computed without regard to any undistributed net income."

(2) CONFORMING AMENDMENT.—Subsection (b) of section 665 is amended by inserting "except as provided in subsection (f)," after "subpart,"

(b) PROPERTY TRANSFERRED TO TRUSTS.—Subsection (e) of section 644 is amended by striking "or" at the end of paragraph (3), by striking the period at the end of paragraph (4) and inserting ", or ", and by adding at the end the following new paragraph:

"(5) in the case of a trust other than a foreign trust, any sale or exchange of property after the date of the enactment of this paragraph."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to distributions in taxable years beginning after the date of the enactment of this Act.

(2) TRANSFERRED PROPERTY.—The amendments made by subsection (b) shall apply to sales or exchanges after the date of the enactment of this Act.

SEC. 508. UNIFIED CREDIT OF DECEDENT INCREASED BY UNIFIED CREDIT OF SPOUSE USED ON SPLIT GIFT INCLUDED IN DECEDENT'S GROSS ESTATE.

(a) IN GENERAL.—Section 2010 (relating to unified credit against estate tax) is amended by adding at the end the following new subsection:

"(d) TREATMENT OF UNIFIED CREDIT USED BY SPOUSE ON SPLIT-GIFT INCLUDED IN DECEDENT'S GROSS ESTATE.—If—

"(1) the decedent was the donor of any gift one-half of which was considered under section 2513 as made by the decedent's spouse, and

"(2) the amount of such gift is includible in the gross estate of the decedent by reason of section 2035, 2036, 2037, or 2038,

the amount of the credit allowable by subsection (a) to the estate of the decedent shall be increased by the amount of the unified credit allowed against the tax imposed by section 2501 on the amount of such gift considered under section 2513 as made by such spouse."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to gifts made after the date of the enactment of this Act.

SEC. 509. REFORMATION OF DEFECTIVE BEQUESTS, ETC., TO SPOUSE OF DECEDENT.

(a) IN GENERAL.—Subsection (b) of section 2056 (relating to bequests, etc., to surviving spouse) is amended by adding at the end the following new paragraph:

"(11) REFORMATIONS PERMITTED.—

"(A) IN GENERAL.—In the case of any interest in property with respect to which a deduction would be allowable under subsection (a) but for a provision of this subsection, if—

"(i) the surviving spouse is entitled to all of the income from the property for life,

"(ii) no person other than such spouse is entitled to any distribution of such property during such spouse's life, and

"(iii) there is a change of a governing instrument (by reformation, amendment, construction, or otherwise) as of the applicable date which results in the satisfaction of the requirements of such provision as of the date of the decedent's death,

the determination of whether such deduction is allowable shall be made as of the applicable date.

"(B) SPECIAL RULE WHERE TIMELY COMMENCEMENT OF REFORMATION.—Clauses (i) and (ii) of subparagraph (A) shall not apply to any interest if, not later than the date described in subparagraph (C)(i), a judicial proceeding is commenced to change such interest into an interest which satisfies the requirements of the provision by reason of which (but for this paragraph) a deduction would not be allowable under subsection (a) for such interest.

"(C) APPLICABLE DATE.—For purposes of subparagraph (A), the term 'applicable date' means—

"(i) the last date (including extensions) for filing the return of tax imposed by this chapter, or

"(ii) if a judicial proceeding is commenced to comply with such provision, the time when the changes pursuant to such proceeding are made.

"(D) SPECIAL RULE.—If the change referred to in subparagraph (A)(iii) is to qualify the passage of the interest under paragraph (7), subparagraph (A) shall apply only if the election under paragraph (7)(B) is made.

"(E) STATUTE OF LIMITATIONS.—If a judicial proceeding described in subparagraph (C)(ii) is commenced with respect to any interest, the period for assessing any deficiency of tax attributable to such interest shall not expire before the date 1 year after the date on which the Secretary is notified that such provision has been complied with or that such proceeding has been terminated."

(b) COMPARABLE RULE FOR GIFT TAX.—Section 2523 (relating to gift to spouse) is amended by adding at the end the following new subsection:

"(j) REFORMATIONS PERMITTED.—Rules similar to the rules of section 2056(b)(11) shall apply for purposes of this section."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying, and gifts made, after the date of the enactment of this Act.

Subtitle B—Generation-Skipping Tax Provisions

SEC. 511. SEVERING OF TRUSTS HOLDING PROPERTY HAVING AN INCLUSION RATIO OF GREATER THAN ZERO.

(a) IN GENERAL.—Subsection (a) of section 2642 (relating to inclusion ratio) is amended by adding at the end the following new paragraph:

"(3) SEVERING OF TRUSTS HOLDING PROPERTY HAVING AN INCLUSION RATIO OF GREATER THAN ZERO.—

"(A) IN GENERAL.—If a trust holding property having an inclusion ratio of greater than zero is severed in a qualified severance, at the election of the trustee of such trust, the trusts resulting from such severance shall be treated as separate trusts for purposes of this chapter and 1 such trust shall have an inclusion ratio of 1 and the other such trust shall have an inclusion ratio of zero.

"(B) QUALIFIED SEVERANCE.—For purposes of subparagraph (A), the term 'qualified severance' means the creation of 2 trusts from a single trust if each property held by the single trust was divided between the 2 created trusts such that one trust received an interest in each such property equal to the applicable fraction of the single trust. Such term includes any other severance permitted under regulations prescribed by the Secretary.

"(C) ELECTION.—The election under this paragraph shall be made at the time prescribed by the Secretary. Such an election, once made, shall be irrevocable."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to severances after the date of the enactment of this Act.

SEC. 512. EXPANSION OF EXCEPTION FROM GENERATION-SKIPPING TRANSFER TAX FOR TRANSFERS TO INDIVIDUALS WITH DECEASED PARENTS.

(a) IN GENERAL.—Section 2651 (relating to generation assignment) is amended by redesignating subsection (e) as subsection (f), and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULE FOR PERSONS WITH A DECEASED PARENT.—

"(1) IN GENERAL.—For purposes of determining whether any transfer is a generation-skipping transfer, if—

"(A) an individual is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and

"(B) such individual's parent who is a lineal descendant of the parent of the transferor (or the transferor's spouse or former spouse) is dead at the time the transfer (from which an interest of such individual is established or derived) is subject to a tax imposed by chapter 11 or 12 upon the transferor (and if there shall be more than 1 such time, then at the earliest such time),

such individual shall be treated as if such individual were a member of the generation which is 1 generation below the lower of the transferor's generation or the generation assignment of the youngest living ancestor of such individual who is also a descendant of the parent of the transferor (or the transferor's spouse or former spouse), and the generation assignment of any descendant of such individual shall be adjusted accordingly.

"(2) LIMITED APPLICATION OF SUBSECTION TO COLLATERAL HEIRS.—This subsection shall not apply with respect to a transfer to any individual who is not a lineal descendant of the transferor (or the transferor's spouse or former spouse) if, at the time of the transfer, such transferor has any living lineal descendant."

(b) CONFORMING AMENDMENTS.—

(1) Section 2612(c) (defining direct skip) is amended by striking paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(2) Section 2612(c)(2) (as so redesignated) is amended by striking "section 2651(e)(2)" and inserting "section 2651(f)(2)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to terminations, distributions, and transfers occurring after December 31, 1997.

TITLE VI—EXTENSIONS

SEC. 601. RESEARCH TAX CREDIT.

(a) IN GENERAL.—Paragraph (1) of section 41(h) (relating to termination) is amended—

(1) by striking "May 31, 1997" and inserting "December 31, 1998", and

(2) by striking in the last sentence "during the first 11 months of such taxable year." and inserting "during the 30-month period beginning with the first month of such year. The 30 months referred to in the preceding sentence shall be reduced by the number of full months after June 1996 (and before the first month of such first taxable year) during which the taxpayer paid or incurred any amount which is taken into account in determining the credit under this section."

(b) TECHNICAL AMENDMENTS.—

(1) Subparagraph (B) of section 41(c)(4) is amended to read as follows:

"(B) ELECTION.—An election under this paragraph shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Secretary."

(2) Paragraph (1) of section 45C(b) is amended by striking "May 31, 1997" and inserting "December 31, 1998".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts paid or incurred after May 31, 1997.

SEC. 602. CONTRIBUTIONS OF STOCK TO PRIVATE FOUNDATIONS.

(a) IN GENERAL.—Clause (ii) of section 170(e)(5)(D) (relating to termination) is amended by striking “May 31, 1997” and inserting “December 31, 1998”.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to contributions made after May 31, 1997.

SEC. 603. WORK OPPORTUNITY TAX CREDIT.

(a) EXTENSION.—

(1) IN GENERAL.—Subparagraph (B) of section 51(c)(4) (relating to termination) is amended by striking “September 30, 1997” and inserting “September 30, 1998”.

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to individuals who begin work for the employer after September 30, 1997.

(b) WORK OPPORTUNITY CREDIT ALLOWED AGAINST MINIMUM TAX.—

(1) IN GENERAL.—Subsection (c) of section 38 (relating to limitation based on amount of tax) is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

“(3) SPECIAL RULES FOR WORK OPPORTUNITY CREDIT.—

“(A) IN GENERAL.—In the case of the work opportunity credit—

“(i) this section and section 39 shall be applied separately with respect to the credit, and

“(ii) in applying paragraph (1) to the credit—

“(I) subparagraph (A) shall not apply, and

“(II) the limitation under paragraph (1) (as modified by subclause (I)) shall be reduced by the credit allowed under subsection (a) for the taxable year (other than the work opportunity credit).

“(B) WORK OPPORTUNITY CREDIT.—For purposes of this subsection, the term ‘work opportunity credit’ means the credit allowable under subsection (a) by reason of section 51(a).”

(2) CONFORMING AMENDMENT.—Subclause (II) of section 38(c)(2)(A)(ii) is amended by inserting “or the work opportunity credit” after “employment credit”.

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to taxable years beginning after December 31, 1997.

(c) PERCENTAGE OF WAGES ALLOWED AS CREDIT.—

(1) IN GENERAL.—Subsection (a) of section 51 (relating to determination of amount) is amended by striking “35 percent” and inserting “40 percent”.

(2) APPLICATION OF CREDIT FOR INDIVIDUALS PERFORMING FEWER THAN 400 HOURS OF SERVICES.—Paragraph (3) of section 51(i) is amended to read as follows:

“(3) INDIVIDUALS NOT MEETING MINIMUM EMPLOYMENT PERIODS.—

“(A) REDUCTION OF CREDIT FOR INDIVIDUALS PERFORMING FEWER THAN 400 HOURS OF SERVICES.—In the case of an individual who has completed at least 120 hours, but less than 400 hours, of services performed for the employer, subsection (a) shall be applied by substituting '25 percent' for '40 percent'.

"(B) DENIAL OF CREDIT FOR INDIVIDUALS PERFORMING FEWER THAN 120 HOURS OF SERVICES.—No wages shall be taken into account under subsection (a) with respect to any individual unless such individual has completed at least 120 hours of services performed for the employer."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to individuals who begin work for the employer after September 30, 1997.

(d) MODIFICATION OF ELIGIBILITY REQUIREMENT BASED ON PERIOD ON WELFARE.—

(1) IN GENERAL.—Subparagraph (A) of section 51(d)(2) (defining qualified IV–A recipient) is amended by striking all that follows "a IV–A program" and inserting "for any 9 months during the 18-month period ending on the hiring date."

(2) CONFORMING AMENDMENT.—Subparagraph (A) of section 51(d)(3) is amended to read as follows:

"(A) IN GENERAL.—The term 'qualified veteran' means any veteran who is certified by the designated local agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for at least a 3-month period ending during the 12-month period ending on the hiring date."

(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to individuals who begin work for the employer after September 30, 1997.

SEC. 604. ORPHAN DRUG TAX CREDIT.

(a) IN GENERAL.—Section 45C (relating to clinical testing expenses for certain drugs for rare diseases or conditions) is amended by striking subsection (e).

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to amounts paid or incurred after May 31, 1997.

TITLE VII—INCENTIVES FOR REVITALIZATION OF THE DISTRICT OF COLUMBIA

SEC. 701. TAX INCENTIVES FOR REVITALIZATION OF THE DISTRICT OF COLUMBIA.

(a) IN GENERAL.—Chapter 1 is amended by adding at the end the following new subchapter:

"Subchapter W—District of Columbia Enterprise Zone

"Sec. 1400. Establishment of DC Zone.
"Sec. 1400A. Tax-exempt economic development bonds.
"Sec. 1400B. Credit for equity investments in and loans to District of Columbia businesses.
"Sec. 1400C. Zero percent capital gains rate.
"Sec. 1400D. Credit to provide equivalent of 10 percent rate bracket in lieu of 15 percent bracket.

"SEC. 1400. ESTABLISHMENT OF DC ZONE.

"(a) IN GENERAL.—The applicable DC area is hereby designated as the District of Columbia Enterprise Zone. For purposes of this title (except as otherwise provided in this subchapter), the District of Columbia Enterprise Zone shall be treated as an empowerment zone designated under subchapter U.

"(b) APPLICABLE DC AREA.—For purposes of subsection (a), the term 'applicable DC area' means the area consisting of—

"(1) the census tracts located in the District of Columbia which are part of an enterprise community designated under subchapter U before the date of the enactment of this subchapter, and

"(2) all other census tracts—

"(A) which are located in the District of Columbia, and

"(B) for which the poverty rate is not less than 35 percent.

"(c) DISTRICT OF COLUMBIA ENTERPRISE ZONE.—For purposes of this subchapter, the terms 'District of Columbia Enterprise Zone' and 'DC Zone' mean the District of Columbia Enterprise Zone designated by subsection (a).

(d) SPECIAL RULE FOR APPLICATION OF EMPLOYMENT CREDIT.—In the case of the DC Zone, section 1396 (relating to empowerment zone employment credit) shall be applied by substituting "20" for "15" in the table contained in section 1396(b). The preceding sentence shall apply only with respect to qualified zone employees, as defined in section 1396(d), determined by treating no area other than the DC Zone as an empowerment zone or enterprise community.

"(e) TIME FOR WHICH DESIGNATION APPLICABLE.—

"(1) IN GENERAL.—The designation made by subsection (a) shall apply for the period beginning on January 1, 1998, and ending on December 31, 2002.

"(2) COORDINATION WITH DC ENTERPRISE COMMUNITY DESIGNATED UNDER SUBCHAPTER U.—The designation as an enterprise community, under subchapter U, of the census tracts referred to in subsection (b)(1) shall terminate on December 31, 2002.

"SEC. 1400A. TAX-EXEMPT ECONOMIC DEVELOPMENT BONDS.

"(a) IN GENERAL.—In the case of the District of Columbia Enterprise Zone—

"(1) subsection (a) of section 1394 (relating to tax-exempt facility bonds for empowerment zones and enterprise communities) applies only with respect to bonds issued by the Economic Development Corporation, and

"(2) subparagraph (A) of section 1394(c)(1) (relating to limitation on amount of bonds) shall be applied by substituting '$15,000,000' for '$3,000,000'.

"(b) ECONOMIC DEVELOPMENT CORPORATION.—For purposes of this section, the term 'Economic Development Corporation' means an entity which is created by Federal law in 1997 as part of the District of Columbia government.

"(c) PERIOD OF APPLICABILITY.—This section shall apply to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2002.

“SEC. 1400B. CREDIT FOR EQUITY INVESTMENTS IN AND LOANS TO DISTRICT OF COLUMBIA BUSINESSES.

“(a) GENERAL RULE.—For purposes of section 38, the DC Zone investment credit determined under this section for any taxable year is—

“(1) the qualified lender credit for such year, and

“(2) the qualified equity investment credit for such year.

“(b) QUALIFIED LENDER CREDIT.—For purposes of this section—

“(1) IN GENERAL.—The qualified lender credit for any taxable year is the amount of credit specified for such year by the Economic Development Corporation with respect to qualified District loans made by the taxpayer.

“(2) LIMITATION.—In no event may the qualified lender credit with respect to any loan exceed 25 percent of the cost of the property purchased with the proceeds of the loan.

“(3) QUALIFIED DISTRICT LOAN.—For purposes of paragraph (1), the term ‘qualified district loan’ means any loan for the purchase (as defined in section 179(d)(2)) of property to which section 168 applies (or would apply but for section 179) (or land which is functionally related and subordinate to such property) and substantially all of the use of which is in the District of Columbia and is in the active conduct of a trade or business in the District of Columbia. A rule similar to the rule of section 1397C(a)(2) shall apply for purposes of the preceding sentence.

“(c) QUALIFIED EQUITY INVESTMENT CREDIT.—

“(1) IN GENERAL.—For purposes of this section, the qualified equity investment credit determined under this section for any taxable year is an amount equal to the percentage specified by the Economic Development Corporation (but not greater than 25 percent) of the aggregate amount paid in cash by the taxpayer during the taxable year for the purchase of District business investments.

“(2) DISTRICT BUSINESS INVESTMENT.—For purposes of this subsection, the term ‘District business investment’ means—

“(A) any District business stock, and

“(B) any District partnership interest.

“(3) DISTRICT BUSINESS STOCK.—For purposes of this subsection—

“(A) IN GENERAL.—Except as provided in subparagraph (B), the term ‘District business stock’ means any stock in a domestic corporation if—

“(i) such stock is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash, and

“(ii) as of the time such stock was issued, such corporation was engaged in a trade or business in the District of Columbia (or, in the case of a new corporation, such corporation was being organized for purposes of engaging in such a trade or business).

“(B) REDEMPTIONS.—A rule similar to the rule of section 1202(c)(3) shall apply for purposes of this paragraph.

"(4) QUALIFIED DISTRICT PARTNERSHIP INTEREST.—For purposes of this subsection, the term 'qualified District partnership interest' means any interest in a partnership if—

"(A) such interest is acquired by the taxpayer from the partnership solely in exchange for cash, and

"(B) as of the time such interest was acquired, such partnership was engaging in a trade or business in the District of Columbia (or, in the case of a new partnership, such partnership was being organized for purposes of engaging in such a trade or business).

A rule similar to the rule of paragraph (3)(B) shall apply for purposes of this paragraph.

"(5) RECAPTURE OF CREDIT UPON CERTAIN DISPOSITIONS OF DISTRICT BUSINESS INVESTMENTS.—

"(A) IN GENERAL.—If a taxpayer disposes of any District business investment (or any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such investment) before the end of the 5-year period beginning on the date such investment was acquired by the taxpayer, the taxpayer's tax imposed by this chapter for the taxable year in which such distribution occurs shall be increased by the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under this section with respect to such investment.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to any gift, transfer, or transaction described in paragraph (1), (2), or (3) of section 1245(b).

"(C) SPECIAL RULE.—Any increase in tax under subparagraph (A) shall not be treated as a tax imposed by this chapter for purposes of—

"(i) determining the amount of any credit allowable under this chapter, and

"(ii) determining the amount of the tax imposed by section 55.

"(6) BASIS REDUCTION.—For purposes of this title, the basis of any District business investment shall be reduced by the amount of the credit determined under this section with respect to such investment.

"(d) LIMITATION ON AMOUNT OF CREDIT.—

"(1) IN GENERAL.—The amount of the DC Zone investment credit determined under this section with respect to any taxpayer for any taxable year shall not exceed the credit amount allocated to such taxpayer for such taxable year by the Economic Development Corporation.

"(2) OVERALL LIMITATION.—The aggregate credit amount which may be allocated by the Economic Development Corporation under this section shall not exceed $75,000,000.

"(3) CRITERIA FOR ALLOCATING CREDIT AMOUNTS.—The allocation of credit amounts under this section shall be made in accordance with criteria established by the Economic Development Corporation. In establishing such criteria, such Corporation shall take into account—

"(A) the degree to which the business receiving the loan or investment will provide job opportunities for low and moderate income residents of the DC Zone, and

"(B) whether such business is within the DC Zone.

"(e) ECONOMIC DEVELOPMENT CORPORATION.—For purposes of this section, the term 'Economic Development Corporation' has the meaning given such term by section 1400A(b).

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out this section.

"(g) APPLICATION OF SECTION.—This section shall apply to any credit amount allocated for taxable years beginning after December 31, 1997, and before January 1, 2003.

"SEC. 1400C. ZERO PERCENT CAPITAL GAINS RATE.

"(a) EXCLUSION.—Gross income shall not include qualified capital gain from the sale or exchange of any DC Zone asset held for more than 5 years.

"(b) DC ZONE ASSET.—For purposes of this section—

"(1) IN GENERAL.—The term 'DC Zone asset' means—

"(A) any DC Zone business stock,

"(B) any DC Zone partnership interest, and

"(C) any DC Zone business property.

"(2) DC ZONE BUSINESS STOCK.—

"(A) IN GENERAL.—The term 'DC Zone business stock' means any stock in a domestic corporation which is originally issued after December 31, 1997, if—

"(i) such stock is acquired by the taxpayer, before January 1, 2003, at its original issue (directly or through an underwriter) solely in exchange for cash,

"(ii) as of the time such stock was issued, such corporation was a DC Zone business (or, in the case of a new corporation, such corporation was being organized for purposes of being a DC Zone business), and

"(iii) during substantially all of the taxpayer's holding period for such stock, such corporation qualified as a DC Zone business.

"(B) REDEMPTIONS.—A rule similar to the rule of section 1202(c)(3) shall apply for purposes of this paragraph.

"(3) DC ZONE PARTNERSHIP INTEREST.—The term 'DC Zone partnership interest' means any capital or profits interest in a domestic partnership which is originally issued after December 31, 1997, if—

"(A) such interest is acquired by the taxpayer, before January 1, 2003, from the partnership solely in exchange for cash,

"(B) as of the time such interest was acquired, such partnership was a DC Zone business (or, in the case of a new partnership, such partnership was being organized for purposes of being a DC Zone business), and

"(C) during substantially all of the taxpayer's holding period for such interest, such partnership qualified as a DC Zone business.

A rule similar to the rule of paragraph (2)(B) shall apply for purposes of this paragraph.

"(4) DC ZONE BUSINESS PROPERTY.—

"(A) IN GENERAL.—The term 'DC Zone business property' means tangible property if—

"(i) such property was acquired by the taxpayer by purchase (as defined in section 179(d)(2)) after December 31, 1997, and before January 1, 2003,

"(ii) the original use of such property in the DC Zone commences with the taxpayer, and

"(iii) during substantially all of the taxpayer's holding period for such property, substantially all of the use of such property was in a DC Zone business of the taxpayer.

"(B) SPECIAL RULE FOR BUILDINGS WHICH ARE SUBSTANTIALLY IMPROVED.—

"(i) IN GENERAL.—The requirements of clauses (i) and (ii) of subparagraph (A) shall be treated as met with respect to—

"(I) property which is substantially improved by the taxpayer before January 1, 2003, and

"(II) any land on which such property is located.

"(ii) SUBSTANTIAL IMPROVEMENT.—For purposes of clause (i), property shall be treated as substantially improved by the taxpayer only if, during any 24-month period beginning after December 31, 1997, additions to basis with respect to such property in the hands of the taxpayer exceed the greater of—

"(I) an amount equal to the adjusted basis of such property at the beginning of such 24-month period in the hands of the taxpayer, or

"(II) $5,000.

"(6) TREATMENT OF SUBSEQUENT PURCHASERS, ETC.—The term 'DC Zone asset' includes any property which would be a DC Zone asset but for paragraph (2)(A)(i), (3)(A), or (4)(A)(ii) in the hands of the taxpayer if such property was a DC Zone asset in the hands of a prior holder.

"(7) 5-YEAR SAFE HARBOR.—If any property ceases to be a DC Zone asset by reason of paragraph (2)(A)(iii), (3)(C), or (4)(A)(iii) after the 5-year period beginning on the date the taxpayer acquired such property, such property shall continue to be treated as meeting the requirements of such paragraph; except that the amount of gain to which subsection (a) applies on any sale or exchange of such property shall not exceed the amount which would be qualified capital gain had such property been sold on the date of such cessation.

"(c) DC ZONE BUSINESS.—For purposes of this section, the term 'DC Zone business' means any entity which is an enterprise zone business (as defined in section 1397B), determined by treating no area other than the DC Zone as an empowerment zone or enterprise community.

"(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) QUALIFIED CAPITAL GAIN.—Except as otherwise provided in this subsection, the term 'qualified capital gain' means any gain recognized on the sale or exchange of—

"(A) a capital asset, or

"(B) property used in the trade or business (as defined in section 1231(b)).

"(2) GAIN BEFORE 1998 OR AFTER 2007 NOT QUALIFIED.—The term 'qualified capital gain' shall not include any gain attributable to periods before January 1, 1998, or after December 31, 2007.

"(3) CERTAIN GAIN ON REAL PROPERTY NOT QUALIFIED.—The term 'qualified capital gain' shall not include any gain which would be treated as ordinary income under section 1250 if section 1250 applied to all depreciation rather than the additional depreciation.

"(4) INTANGIBLES AND LAND NOT INTEGRAL PART OF DC ZONE BUSINESS.—The term 'qualified capital gain' shall not include any gain which is attributable to real property, or an intangible asset, which is not an integral part of a DC Zone business.

"(5) RELATED PARTY TRANSACTIONS.—The term 'qualified capital gain' shall not include any gain attributable, directly or indirectly, in whole or in part, to a transaction with a related person. For purposes of this paragraph, persons are related to each other if such persons are described in section 267(b) or 707(b)(1).

"(e) CERTAIN OTHER RULES TO APPLY.—Rules similar to the rules of subsections (g), (h), (i)(2), and (j) of section 1202 shall apply for purposes of this section.

"(f) SALES AND EXCHANGES OF INTERESTS IN PARTNERSHIPS AND S CORPORATIONS WHICH ARE DC ZONE BUSINESSES.—In the case of the sale or exchange of an interest in a partnership, or of stock in an S corporation, which was a DC Zone business during substantially all of the period the taxpayer held such interest or stock, the amount of qualified capital gain shall be determined without regard to—

"(1) any gain which is attributable to real property, or an intangible asset, which is not an integral part of a DC Zone business, and

"(2) any gain attributable to periods before January 1, 1998, or after December 31, 2007.

"SEC. 1400D. CREDIT TO PROVIDE EQUIVALENT OF 10 PERCENT RATE BRACKET IN LIEU OF 15 PERCENT BRACKET.

"(a) IN GENERAL.—In the case of a DC Zone individual, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 5 percent of so much of the taxpayer's taxable income for the year as does not exceed the highest amount of such income which is subject to the 15 percent rate under section 1.

"(b) DC ZONE INDIVIDUAL.—For purposes of this section, the term 'DC Zone individual' means an individual who has a principal place of abode in the District of Columbia Enterprise Zone for not less than 183 days of the taxable year.

"(c) CREDIT NOT TO APPLY TO ESTATE OR TRUST.—This section shall not apply to an estate or trust.

"(d) COORDINATION WITH OTHER CREDITS.—For purposes of this chapter, the credit under this section shall be treated as a credit under subpart A of part IV of subchapter A.

"(e) TERMINATION.—This section shall not apply to any taxable year beginning after December 31, 2007."

(b) CREDITS MADE PART OF GENERAL BUSINESS CREDIT.—

(1) Subsection (b) of section 38 is amended by striking "plus" at the end of paragraph (11), by striking the period at the end of paragraph (12) and inserting ", plus", and by adding at the end the following new paragraph:

"(13) the DC Zone investment credit determined under section 1400B(a)."

(2) Subsection (d) of section 39 is amended by adding at the end the following new paragraph:

"(8) NO CARRYBACK OF DC ZONE CREDITS BEFORE EFFECTIVE DATE.—No portion of the unused business credit for any taxable year which is attributable to the credit under section 1400B, or to the credits under subchapter U by reason of section 1400, may be carried back to a taxable year ending before the date of the enactment of sections 1400B and 1400."

(3) Subsection (c) of section 196 is amended by striking "and" at the end of paragraph (6), by striking the period at the end of paragraph (7) and inserting ", and", and by adding at the end the following new paragraph:

"(8) the DC Zone investment credit determined under section 1400B(a)."

(c) CLERICAL AMENDMENT.—The table of subchapters for chapter 1 is amended by adding at the end the following new item:

"Subchapter W. District of Columbia Enterprise Zone."

(d) EFFECTIVE DATE.—This section shall take effect on the date of the enactment of this Act.

SEC. 702. INCENTIVES CONDITIONED ON OTHER DC REFORM.

The amendments made by section 701 shall not take effect unless an entity known as the Economic Development Corporation is created by Federal law in 1997 as part of the District of Columbia government.

TITLE VIII—WELFARE-TO-WORK INCENTIVES

SEC. 801. INCENTIVES FOR EMPLOYING LONG-TERM FAMILY ASSISTANCE RECIPIENTS.

(a) IN GENERAL.—Subpart F of part IV of subchapter A of chapter 1 is amended by inserting after section 51 the following new section:

"SEC. 51A. TEMPORARY INCENTIVES FOR EMPLOYING LONG-TERM FAMILY ASSISTANCE RECIPIENTS.

"(a) DETERMINATION OF AMOUNT.—For purposes of section 38, the amount of the welfare-to-work credit determined under this section for the taxable year shall be equal to—

"(1) 35 percent of the qualified first-year wages for such year, and

"(2) 50 percent of the qualified second-year wages for such year.

"(b) QUALIFIED WAGES DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'qualified wages' means the wages paid or incurred by the employer during the taxable year to individuals who are long-term family assistance recipients.

"(2) QUALIFIED FIRST-YEAR WAGES.—The term 'qualified first-year wages' means, with respect to any individual, qualified wages attributable to service rendered during the 1-year period beginning with the day the individual begins work for the employer.

"(3) QUALIFIED SECOND-YEAR WAGES.—The term 'qualified second-year wages' means, with respect to any individual, qualified wages attributable to service rendered during the 1-year period beginning on the day after the last day of the 1-year period with respect to such individual determined under paragraph (2).

"(4) ONLY FIRST $10,000 OF WAGES PER YEAR TAKEN INTO ACCOUNT.—The amount of the qualified first-year wages, and the amount of qualified second-year wages, which may be taken into account with respect to any individual shall not exceed $10,000 per year.

"(5) WAGES.—

"(A) IN GENERAL.—The term 'wages' has the meaning given such term by section 51(c), without regard to paragraph (4) thereof.

"(B) CERTAIN AMOUNTS TREATED AS WAGES.—The term 'wages' includes amounts paid or incurred by the employer which are excludable from such recipient's gross income under—

"(i) section 105 (relating to amounts received under accident and health plans),

"(ii) section 106 (relating to contributions by employer to accident and health plans),

"(iii) section 127 (relating to educational assistance programs) or would be so excludable but for section 127(d), but only to the extent paid or incurred to a person not related to the employer, or

"(iv) section 129 (relating to dependent care assistance programs).

The amount treated as wages by clause (i) or (ii) for any period shall be based on the reasonable cost of coverage for the period, but shall not exceed the applicable premium for the period under section 4980B(f)(4).

"(C) SPECIAL RULES FOR AGRICULTURAL AND RAILWAY LABOR.—If such recipient is an employee to whom subparagraph (A) or (B) of section 51(h)(1) applies, rules similar to the rules of such subparagraphs shall apply except that—

"(i) such subparagraph (A) shall be applied by substituting '$10,000' for '$6,000', and

"(ii) such subparagraph (B) shall be applied by substituting '$833.33' for '$500'.

"(c) LONG-TERM FAMILY ASSISTANCE RECIPIENTS.—For purposes of this section—

"(1) IN GENERAL.—The term 'long-term family assistance recipient' means any individual who is certified by the designated local agency (as defined in section 51(d)(10))—

"(A) as being a member of a family receiving assistance under a IV-A program (as defined in section 51(d)(2)(B)) for at least the 18-month period ending on the hiring date.

"(B)(i) as being a member of a family receiving such assistance for 18 months beginning after the date of the enactment of this section, and

"(ii) as having a hiring date which is not more than 2 years after the end of the earliest such 18-month period, or

"(C)(i) as being a member of a family which ceased to be eligible after the date of the enactment of this section for such assistance by reason of any limitation imposed by Federal or State law on the maximum period such assistance is payable to a family, and

"(ii) as having a hiring date which is not more than 2 years after the date of such cessation.

"(2) HIRING DATE.—The term 'hiring date' has the meaning given such term by section 51(d).

"(d) CERTAIN RULES TO APPLY.—

"(1) IN GENERAL.—Rules similar to the rules of section 52, and subsections (d)(11), (f), (g), (i) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1997), (j), and (k) of section 51, shall apply for purposes of this section.

"(2) CREDIT TO BE PART OF GENERAL BUSINESS CREDIT, ETC.—References to section 51 in section 38(b), 280C(a), and 1396(c)(3) shall be treated as including references to this section.

"(e) COORDINATION WITH WORK OPPORTUNITY CREDIT.—If a credit is allowed under this section to an employer with respect to an individual for any taxable year, then for purposes of applying section 51 to such employer, such individual shall not be treated as a member of a targeted group for such taxable year.

"(f) TERMINATION.—This section shall not apply to individuals who begin work for the employer after April 30, 1999."

(b) CLERICAL AMENDMENT.—The table of sections for subpart F of part IV of subchapter A of chapter 1 is amended by inserting after the item relating to section 51 the following new item:

"Sec. 51A. Temporary incentives for employing long-term family assistance recipients."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to individuals who begin work for the employer after December 31, 1997.

TITLE IX—MISCELLANEOUS PROVISIONS

Subtitle A—Provisions Relating to Excise Taxes

SEC. 901. REPEAL OF TAX ON DIESEL FUEL USED IN RECREATIONAL BOATS.

(a) IN GENERAL.—Subparagraph (B) of section 6421(e)(2) (defining off-highway business use) is amended by striking clauses (iii) and (iv).

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (A) of section 4041(a)(1) is amended—

(A) by striking ", a diesel-powered train, or a diesel-powered boat" each place it appears and inserting "or a diesel-powered train", and

(B) by striking "vehicle, train, or boat" and inserting "vehicle or train".

(2) Paragraph (1) of section 4041(a) is amended by striking subparagraph (D).

(3) Paragraph (2) of section 9503(f) is amended by striking subparagraph (C) and by redesignating subparagraphs (D) and (E) as subparagraphs (C) and (D), respectively.

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1998.

SEC. 902. CONTINUED APPLICATION OF TAX ON IMPORTED RECYCLED HALON–1211.

(a) IN GENERAL.—Paragraph (1) of section 4682(d) is amended by striking "recycled halon" and inserting "recycled Halon–1301 or recycled Halon–2402".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 903. UNIFORM RATE OF TAX ON VACCINES.

(a) IN GENERAL.—Subsection (b) of section 4131 is amended to read as follows:

"(b) AMOUNT OF TAX.—

"(1) IN GENERAL.—The amount of the tax imposed by subsection (a) shall be 84 cents per dose of any taxable vaccine.

"(2) COMBINATIONS OF VACCINES.—If any taxable vaccine is described in more than 1 subparagraph of section 4132(a)(1), the amount of the tax imposed by subsection (a) on such vaccine shall be the sum of the amounts for the vaccines which are so included."

(b) TAXABLE VACCINES.—Paragraph (1) of section 4132(a) is amended to read as follows:

"(1) TAXABLE VACCINE.—The term 'taxable vaccine' means any of the following vaccines which are manufactured or produced in the United States or entered into the United States for consumption, use, or warehousing:

"(A) Any vaccine containing diphtheria toxoid.

"(B) Any vaccine containing tetanus toxoid.

"(C) Any vaccine containing pertussis bacteria, extracted or partial cell bacteria, or specific pertussis antigens.

"(D) Any vaccine against measles.

"(E) Any vaccine against mumps.

"(F) Any vaccine against rubella.

"(G) Any vaccine containing polio virus.

"(H) Any HIB vaccine.

"(I) Any vaccine against hepatitis B.

"(J) Any vaccine against chicken pox."

(c) CONFORMING AMENDMENT.—Subsection (a) of section 4132 is amended by striking paragraphs (2), (3), and (4) and by redesignating paragraphs (5) through (8) as paragraphs (2) through (5), respectively.

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on October 1, 1997.

SEC. 904. OPERATORS OF MULTIPLE GASOLINE RETAIL OUTLETS TREATED AS WHOLESALE DISTRIBUTOR FOR REFUND PURPOSES.

(a) IN GENERAL.—Subparagraph (B) of section 6416(a)(4) (defining whole distributor) is amended by adding at the end the following new sentence: "Such term includes any person who makes retail sales of gasoline at 10 or more retail motor fuel outlets."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 905. EXEMPTION OF ELECTRIC AND OTHER CLEAN-FUEL MOTOR VEHICLES FROM LUXURY AUTOMOBILE CLASSIFICATION.

(a) IN GENERAL.—Subsection (a) of section 4001 (relating to imposition of tax) is amended to read as follows:

"(a) IMPOSITION OF TAX.—

"(1) IN GENERAL.—There is hereby imposed on the 1st retail sale of any passenger vehicle a tax equal to 10 percent of the price for which so sold to the extent such price exceeds the applicable amount.

"(2) APPLICABLE AMOUNT.—

"(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), the applicable amount is $30,000.

"(B) QUALIFIED CLEAN-FUEL VEHICLE PROPERTY.—In the case of a passenger vehicle which is propelled by a fuel which is not a clean-burning fuel to which is installed qualified clean-fuel vehicle property (as defined in section 179A(c)(1)(A)) for purposes of permitting such vehicle to be propelled by a clean-burning fuel, the applicable amount is equal to the sum of—

"(i) $30,000, plus

"(ii) the increase in the price for which the passenger vehicle was sold (within the meaning of section 4002) due to the installation of such property.

"(C) PURPOSE BUILT PASSENGER VEHICLE.—

"(i) IN GENERAL.—In the case of a purpose built passenger vehicle, the applicable amount is equal to 150 percent of $30,000.

"(ii) PURPOSE BUILT PASSENGER VEHICLE.—For purposes of clause (i), the term 'purpose built passenger vehicle' means a passenger vehicle produced by an original equipment manufacturer and designed so that the vehicle may be propelled primarily by electricity."

(b) CONFORMING AMENDMENTS.—

(1) Subsection (e) of section 4001 (relating to inflation adjustment) is amended to read as follows:

"(e) INFLATION ADJUSTMENT.—

"(1) IN GENERAL.—The $30,000 amount in subparagraphs (A), (B)(i), and (C)(i) of subsection (a)(2) shall be increased by an amount equal to—

"(A) $30,000, multiplied by

"(B) the cost-of-living adjustment under section 1(f)(3) for the calendar year in which the vehicle is sold, determined by substituting 'calendar year 1990' for 'calendar year 1992' in subparagraph (B) thereof.

"(2) ROUNDING.—If any amount as adjusted under paragraph (1) is not a multiple of $2,000, such amount shall be rounded to the next lowest multiple of $2,000."

(2) Subsection (f) of section 4001 (relating to phasedown) is amended by striking "subsection (a)" and inserting "subsection (a)(1)".

(3) Subparagraph (B) of section 4003(a)(2) is amended to read as follows:

"(B) the appropriate applicable amount as determined under section 4001(a)(2)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales and installations occurring on or after the date of the enactment of this Act.

Subtitle B—Provisions Relating to Pensions and Fringe Benefits

SEC. 911. SECTION 401(K) PLANS FOR CERTAIN IRRIGATION AND DRAINAGE ENTITIES.

(a) IN GENERAL.—Subparagraph (B) of section 401(k)(7) (relating to rural cooperative plan) is amended—

(1) by striking "and" at the end of clause (iii), by redesignating clause (iv) as clause (v), and by inserting after clause (iii) the following new clause:

"(iv) any organization which—

"(I) is a mutual irrigation or ditch company described in section 501(c)(12) (without regard to the 85 percent requirement thereof), or

"(II) is a district organized under the laws of a State as a municipal corporation for the purpose of irrigation, water conservation, or drainage, and", and

(2) in clause (v), as so redesignated, by striking "or (iii)" and inserting ", (iii), or (iv)".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to years beginning after December 31, 1997.

SEC. 912. EXTENSION OF MORATORIUM ON APPLICATION OF CERTAIN NONDISCRIMINATION RULES TO STATE AND LOCAL GOVERNMENTS.

(a) GENERAL NONDISCRIMINATION AND PARTICIPATION RULES.—

(1) NONDISCRIMINATION REQUIREMENTS.—Section 401(a)(5) (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by adding at the end the following:

"(G) GOVERNMENTAL PLANS.—Paragraphs (3) and (4) shall not apply to a governmental plan (within the meaning of section 414(d)).".

(2) ADDITIONAL PARTICIPATION REQUIREMENTS.—Section 401(a)(26)(H) (relating to additional participation requirements) is amended to read as follows:

"(H) EXCEPTION FOR GOVERNMENTAL PLANS.—This paragraph shall not apply to a governmental plan (within the meaning of section 414(d)).".

(3) MINIMUM PARTICIPATION STANDARDS.—Section 410(c)(2) (relating to application of participation standards to certain plans) is amended to read as follows:

"(2) A plan described in paragraph (1) shall be treated as meeting the requirements of this section for purposes of section 401(a), except that in the case of a plan described in subparagraph (B), (C), or (D) of paragraph (1), this paragraph shall only apply if such plan meets the requirements of section 401(a)(3) (as in effect on September 1, 1974).".

(b) PARTICIPATION STANDARDS FOR QUALIFIED CASH OR DEFERRED ARRANGEMENTS.—Section 401(k)(3) (relating to application of participation and discrimination standards) is amended by adding at the end the following:

"(G)(i) The requirements of subparagraph (A)(i) and (C) shall not apply to a governmental plan (within the meaning of section 414(d)).

"(ii) The requirements of subsection (m)(2) (without regard to subsection (a)(4)) shall apply to any matching contribution of a governmental plan (as so defined).".

(c) NONDISCRIMINATION RULES FOR SECTION 403(b) PLANS.—Section 403(b)(12) (relating to nondiscrimination requirements) is amended by adding at the end the following:

"(C) GOVERNMENTAL PLANS.—For purposes of paragraph (1)(D), the requirements of subparagraph (A)(i) shall not apply to a governmental plan (within the meaning of section 414(d)).".

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section apply to taxable years beginning on or after the date of enactment of this Act.

(2) TREATMENT FOR YEARS BEGINNING BEFORE DATE OF ENACTMENT.—A governmental plan (within the meaning of section 414(d) of the Internal Revenue Code of 1986) shall be treated as satisfying the requirements of sections 401(a)(3), 401(a)(4), 401(a)(26), 401(k), 401(m), 403 (b)(1)(D) and (b)(12), and 410 of such Code for all taxable years beginning before the date of enactment of this Act.

SEC. 913. TREATMENT OF CERTAIN DISABILITY BENEFITS RECEIVED BY FORMER POLICE OFFICERS OR FIREFIGHTERS.

(a) GENERAL RULE.—For purposes of determining whether any amount to which this section applies is excludable from gross income under section 104(a)(1) of the Internal Revenue Code of 1986, the following conditions shall be treated as personal injuries or sickness in the course of employment:

(1) Heart disease.

(2) Hypertension.

(b) AMOUNTS TO WHICH SECTION APPLIES.—This section shall apply to any amount—

(1) which is payable—

(A) to an individual (or to the survivors of an individual) who was a full-time employee of any police department or fire department which is organized and operated by a State, by any political subdivision thereof, or by any agency or instrumentality of a State or political subdivision thereof, and

(B) under 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; and

(2) which was received in calendar year 1989, 1990, or 1991.

(c) WAIVER OF STATUTE OF LIMITATIONS.—If, on the date of the enactment of this Act (or at any time within the 1-year period beginning on such date of enactment) credit or refund of any overpayment of tax resulting from the provisions of this section is barred by any law or rule of law, credit or refund of such overpayment shall, nevertheless, be allowed or made if claim therefore is filed before the date 1 year after such date of enactment.

SEC. 914. PORTABILITY OF PERMISSIVE SERVICE CREDIT UNDER GOVERNMENTAL PENSION PLANS.

(a) IN GENERAL.—Section 415(b)(2) (relating to the limitation for defined benefit plans) is amended by adding at the end the following new subparagraph:

"(J) PURCHASE OF PERMISSIVE SERVICE CREDIT.—

"(i) BENEFITS TREATED AS DERIVED FROM EMPLOYER CONTRIBUTIONS.—For purposes of this section, the term 'annual benefit' shall include the accrued benefit derived from contributions to a governmental plan (within the meaning of section 414(d)) to purchase permissive service credit.

"(ii) DEFINITION OF PERMISSIVE SERVICE CREDIT.—For purposes of this subparagraph, the term 'permissive service credit' means credit—

"(I) for a period of service recognized by a governmental plan for purposes of calculating an employee's accrued benefit under such plan,

"(II) which such employee has not received (or has forfeited), and

"(III) which such employee may receive only by making a contribution, as determined under the governmental plan, which does not exceed the amount (actuarially determined under the terms of such governmental plan) necessary to fund the accrued benefit attributable to such period of service.

"(iii) NO EFFECT ON EMPLOYER 'PICK-UP' CONTRIBUTIONS.—Nothing in this subparagraph shall be construed as preventing the application of section 414(h) to contributions to purchase permissive service credit."

(b) CONFORMING AMENDMENT.—Section 415(c)(2) is amended by adding at the end the following new sentence: "The term 'annual addition' shall not include contributions to purchase permissive service credit (within the meaning of subsection (b)(2)(J))."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after December 31, 1997.

SEC. 915. GRATUITOUS TRANSFERS FOR THE BENEFIT OF EMPLOYEES.

(a) IN GENERAL.—Subparagraph (C) of section 664(d)(1) and subparagraph (C) of section 664(d)(2) are each amended by striking the period at the end thereof and inserting "or, to the extent the remainder interest is in qualified employer securities (as defined in paragraph (3)(C)), is to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by subsection (g))."

(b) QUALIFIED GRATUITOUS TRANSFER DEFINED.—Section 664 is amended by adding at the end the following new subsection:

"(g) QUALIFIED GRATUITOUS TRANSFER OF QUALIFIED EMPLOYER SECURITIES.—

"(1) IN GENERAL.—For purposes of this section, the term 'qualified gratuitous transfer' means a transfer of qualified employer securities to an employee stock ownership plan (as defined in section 4975(e)(7)) but only to the extent that—

"(A) the securities transferred previously passed from a decedent dying before January 1, 1999, to a trust described in paragraph (1) or (2) of subsection (d),

"(B) no deduction under section 404 is allowable with respect to such transfer,

"(C) such plan contains the provisions required by paragraph (3),

"(D) such plan treats such securities as being attributable to employer contributions but without regard to the limitations otherwise applicable to such contributions under section 404, and

"(E) the employer whose employees are covered by the plan described in this paragraph files with the Secretary a verified written statement consenting to the application of sections 4978 and 4979A with respect to such employer.

"(2) EXCEPTION.—The term 'qualified gratuitous transfer' shall not include a transfer of qualified employer securities to an employee stock ownership plan unless—

"(A) such plan was in existence on August 1, 1996,

"(B) at the time of the transfer, the decedent and members of the decedent's family (within the meaning of section 267(c)(4)) own (directly or through the application of section 318(a)) no more than 10 percent of the value of the stock of the corporation referred to in paragraph (4), and

"(C) immediately after the transfer, such plan owns (after the application of section 318(a)(4)) at least 60 percent of the value of the outstanding stock of the corporation.

"(3) PLAN REQUIREMENTS.—A plan contains the provisions required by this paragraph if such plan provides that—

"(A) the qualified employer securities so transferred are allocated to plan participants in a manner consistent with section 401(a)(4),

"(B) plan participants are entitled to direct the plan as to the manner in which such securities which are entitled to vote and are allocated to the account of such participant are to be voted,

"(C) an independent trustee votes the securities so transferred which are not allocated to plan participants,

"(D) each participant who is entitled to a distribution from the plan has the rights described in subparagraphs (A) and (B) of section 409(h)(1),

"(E) such securities are held in a suspense account under the plan to be allocated each year, up to the limitations under section 415(c), after first allocating all other annual additions for the limitation year, up to the limitations under sections 415 (c) and (e), and

"(F) on termination of the plan, all securities so transferred which are not allocated to plan participants as of such termination are to be transferred to, or for the use of, an organization described in section 170(c).

For purposes of the preceding sentence, the term 'independent trustee' means any trustee who is not a member of the family (within the meaning of section 267(c)(4)) of the decedent or a 5-percent shareholder. A plan shall not fail to be treated as meeting the requirements of section 401(a) by reason of meeting the requirements of this subsection.

"(4) QUALIFIED EMPLOYER SECURITIES.—For purposes of this section, the term 'qualified employer securities' means employer securities (as defined in section 409(l)) which are issued by a domestic corporation—

"(A) which has no outstanding stock which is readily tradable on an established securities market, and

"(B) which has only 1 class of stock.

"(5) TREATMENT OF SECURITIES ALLOCATED BY EMPLOYEE STOCK OWNERSHIP PLAN TO PERSONS RELATED TO DECEDENT OR 5-PERCENT SHAREHOLDERS.—

"(A) IN GENERAL.—If any portion of the assets of the plan attributable to securities acquired by the plan in a qualified gratuitous transfer are allocated to the account of—

"(i) any person who is related to the decedent (within the meaning of section 267(b)), or

"(ii) any person who, at the time of such allocation or at any time during the 1-year period ending on the date of the acquisition of qualified employer securities by the plan, is a 5-percent shareholder of the employer maintaining the plan, the plan shall be treated as having distributed (at the time of such allocation) to such person or shareholder the amount so allocated.

"(B) 5-PERCENT SHAREHOLDER.—For purposes of subparagraph (A), the term '5-percent shareholder' means any person who owns (directly or through the application of section 318(a)) more than 5 percent of the outstanding stock of the corporation which issued such qualified employer securities or of any corporation which is a member of the same controlled group of corporations (within the meaning of section 409(l)(4)) as such corporation. For purposes of the preceding sentence, section 318(a) shall be applied without regard to the exception in paragraph (2)(B)(i) thereof.

"(C) CROSS REFERENCE.—

"For excise tax on allocations described in subparagraph (A), see section 4979A.

"(6) TAX ON FAILURE TO TRANSFER UNALLOCATED SECURITIES TO CHARITY ON TERMINATION OF PLAN.—If the requirements of paragraph (3)(F) are not met with respect to any securities, there is hereby imposed a tax on the employer maintaining the plan in an amount equal to the sum of—

"(A) the amount of the increase in the tax which would be imposed by chapter 11 if such securities were not transferred as described in paragraph (1), and

"(B) interest on such amount at the underpayment rate under section 6621 (and compounded daily) from the due date for filing the return of the tax imposed by chapter 11."

(c) CONFORMING AMENDMENTS.—

(1) Section 401(a)(1) is amended by inserting "or by a charitable remainder trust pursuant to a qualified gratuitous transfer (as defined in section 664(g)(1))," after "stock bonus plans),".

(2) Section 404(a)(9) is amended by inserting after subparagraph (B) the following new subparagraph:

"(C) A qualified gratuitous transfer (as defined in section 664(g)(1)) shall have no effect on the amount or amounts otherwise deductible under paragraph (3) or (7) or under this paragraph."

(3) Section 415(c)(6) is amended by adding at the end thereof the following new sentence:

"The amount of any qualified gratuitous transfer (as defined in section 664(g)(1)) allocated to a participant for any limitation year shall not exceed the limitations imposed by this section, but such amount shall not be taken into account in determining whether any other amount exceeds the limitations imposed by this section."

(4) Section 415(e) is amended—

(A) by redesignating paragraph (6) as paragraph (7), and

(B) by inserting after paragraph (5) the following new paragraph:

"(6) SPECIAL RULE FOR QUALIFIED GRATUITOUS TRANSFERS.—Any qualified gratuitous transfer of qualified employer securities (as defined by section 664(g)) shall not be taken into account in calculating, and shall not be subject to, the limitations provided in this subsection."

(5) Subparagraph (B) of section 664(d)(1) and subparagraph (B) of section 664(d)(2) are each amended by inserting "and other than qualified gratuitous transfers described in subparagraph (C)" after "subparagraph (A)".

(6) Paragraph (4) of section 674(b) is amended by inserting before the period "or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1))".

(7) Section 2055(a) is amended—

(i) by striking "or" at the end of paragraph (3),

(ii) by striking the period at the end of paragraph (4) and inserting "; or", and

(iii) by inserting after paragraph (4) the following new paragraph:

"(5) to an employee stock ownership plan if such transfer qualifies as a qualified gratuitous transfer of qualified employer securities within the meaning of section 664(g)."

(8) Paragraph (8) of section 2056(b) is amended to read as follows:

"(8) SPECIAL RULE FOR CHARITABLE REMAINDER TRUSTS.—

"(A) IN GENERAL.—If the surviving spouse of the decedent is the only beneficiary of a qualified charitable remainder trust who is not a charitable beneficiary nor an ESOP beneficiary, paragraph (1) shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse.

"(B) DEFINITIONS.—For purposes of subparagraph (A)—

"(i) CHARITABLE BENEFICIARY.—The term 'charitable beneficiary' means any beneficiary which is an organization described in section 170(c).

"(ii) ESOP BENEFICIARY.—The term 'ESOP beneficiary' means any beneficiary which is an employee stock ownership plan (as defined in section 4975(e)(7)) that holds a remainder interest in qualified employer securities (as defined in section 664(g)(4)) to be transferred to such plan in a qualified gratuitous transfer (as defined in section 664(g)(1)).

"(iii) QUALIFIED CHARITABLE REMAINDER TRUST.— The term 'qualified charitable remainder trust' means a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664)."

(9) Section 4947(b) is amended by inserting after paragraph (3) the following new paragraph:

"(4) SECTION 507.—The provisions of section 507(a) shall not apply to a trust which is described in subsection (a)(2) by reason of a distribution of qualified employer securities (as defined in section 664(g)(4)) to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined by section 664(g))."

(10) The last sentence of section 4975(e)(7) is amended by inserting "and section 664(g)" after "section 409(n)"

(11) Subsection (a) of section 4978 is amended—

(A) by inserting "or acquired any qualified employer securities in a qualified gratuitous transfer to which section 664(g) applied" after "section 1042 applied", and

(B) by inserting before the period at the end of subparagraph (B) "60 percent of the total value of all employer securities as of such disposition in the case of any qualified employer securities in a qualified gratuitous transfer to which section 664(g) applied)".

(12) Paragraph (2) of section 4978(b) is amended—

(A) by inserting "or acquired in the qualified gratuitous transfer to which section 664(g) applied" after "section 1042 applied", and

(B) by inserting "or to which section 664(g) applied" after "section 1042 applied" in subparagraph (C) thereof.

(13) Subsection (c) of section 4978 is amended by striking "written statement" and all that follows and inserting "written statement described in section 664(g)(1)(E) or in section 1042(b)(3) (as the case may be)."

(14) Paragraph (2) of section 4978(e) is amended by striking the period and inserting "; except that such section shall be applied without regard to subparagraph (B) thereof for purposes of applying this section and section 4979A with respect to securities acquired in a qualified gratuitous transfer (as defined in section 664(g)(1))."

(15) Subsection (a) of section 4979A is amended to read as follows:

"(a) IMPOSITION OF TAX.—If—

"(1) there is a prohibited allocation of qualified securities by any employee stock ownership plan or eligible worker-owned cooperative, or

"(2) there is an allocation described in section 664(g)(5)(A),

there is hereby imposed a tax on such allocation equal to 50 percent of the amount involved."

(16) Subsection (c) of section 4979A is amended to read as follows:

"(c) LIABILITY FOR TAX.—The tax imposed by this section shall be paid by—

"(1) the employer sponsoring such plan, or

"(2) the eligible worker-owned cooperative,

which made the written statement described in section 664(g)(1)(E) or in section 1042(b)(3)(B) (as the case may be)."

(17) Section 4979A is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) SPECIAL STATUTE OF LIMITATIONS FOR TAX ATTRIBUTABLE TO CERTAIN ALLOCATIONS.—The statutory period for the assessment of any tax imposed by this section on an allocation described in subsection (a)(2) of qualified employer securities shall not expire before the date which is 3 years from the later of—

"(1) the 1st allocation of such securities in connection with a qualified gratuitous transfer (as defined in section 664(g)(1)), or

"(2) the date on which the Secretary is notified of the allocation described in subsection (a)(2)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers made by trusts to, or for the use of, an employee stock ownership plan after the date of the enactment of this Act.

SEC. 916. TREATMENT OF CERTAIN TRANSPORTATION ON NON-COMMERCIALLY OPERATED AIRCRAFT AS A FRINGE BENEFIT EXCLUDABLE FROM GROSS INCOME.

(a) IN GENERAL.—Subsection (b) of section 132 (relating to no-additional-cost service defined) is amended to read as follows:

"(b) NO-ADDITIONAL-COST SERVICE DEFINED.—For purposes of this section, the term 'no-additional-cost service' means any service provided by an employer to an employee for use by such employee if—

"(1) such service—

"(A) is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, or

"(B) consists of transportation on an aircraft, if—

"(i) transportation on such aircraft is not offered for sale to customers,

"(ii) such transportation for use by such employee is provided on a flight made in the ordinary course of the trade or business of an employer which owns or leases such aircraft for use in such trade or business, and

"(iii) the flight on which the transportation is provided would have been made whether or not such employee was transported on the flight, and

"(2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to services provided after December 31, 1997.

SEC. 917. MINIMUM PENSION ACCRUED BENEFIT DISTRIBUTABLE WITHOUT CONSENT INCREASED TO $5,000.

(a) IN GENERAL.—Subparagraph (A) of section 411(a)(11) (relating to restrictions on certain mandatory distributions) is amended by striking "$3,500" and inserting "the applicable limit".

(b) APPLICABLE LIMIT.—Paragraph (11) of section 411(a) is amended by adding at the end the following new subparagraph:

"(D) APPLICABLE LIMIT.—

"(i) IN GENERAL.—For purposes of subparagraph (A), the applicable limit is $5,000.

"(ii) INFLATION ADJUSTMENT.—In the case of plan years beginning in a calendar year after 1998, the dollar amount contained in clause (i) shall be increased by an amount equal to—

"(I) such dollar amount, multiplied by

"(II) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $50, such amount shall be rounded to the next lowest multiple of $50."

(c) CONFORMING AMENDMENTS.—

(1) Section 411(a)(7)(B), paragraphs (1) and (2) of section 417(e), and section 457(e)(9) are each amended by striking "$3,500" each place in appears (other than the headings) and inserting "the applicable limit under section 411(a)(11)(D)".

(2) The headings for paragraphs (1) and (2) of section 417(e) and subparagraph (A) of section 457(e)(9) are each amended by striking "$3,500" and inserting "APPLICABLE LIMIT".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after the date of the enactment of this Act.

SEC. 918. CLARIFICATION OF CERTAIN RULES RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS OF S CORPORATIONS.

(a) CERTAIN CASH DISTRIBUTIONS PERMITTED.—

(1) Paragraph (2) of section 409(h) is amended by adding at the end the following new subparagraph:

"(B) PLAN MAINTAINED BY S CORPORATION.—In the case of a plan established and maintained by an S corporation which otherwise meets the requirements of this subsection or section 4975(e)(7), such plan shall not be treated as failing to meet the requirements of this subsection or section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash."

(2) Paragraph (2) of section 409(h) is amended—

(A) by striking "a plan which" in the first sentence and inserting the following:

"(A) IN GENERAL.—A plan which", and

(B) by moving the text before subparagraph (B) 2 ems to the right.

(b) SHAREHOLDER-EMPLOYEES NOT TREATED AS OWNER-EMPLOYEES UNDER TAX ON PROHIBITED TRANSACTIONS.—The last sentence of section 4975(d) is amended by striking all that follows "preceding sentence," through "Revision Act of 1982,".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

Subtitle C—Revisions Relating to Disasters

SEC. 921. AUTHORITY TO POSTPONE CERTAIN TAX-RELATED DEADLINES BY REASON OF PRESIDENTIALLY DECLARED DISASTER.

(a) IN GENERAL.—Chapter 77 is amended by inserting after section 7508 the following new section:

"SEC. 7508A. AUTHORITY TO POSTPONE CERTAIN TAX-RELATED DEADLINES BY REASON OF PRESIDENTIALLY DECLARED DISASTER.

"(a) IN GENERAL.—In the case of a taxpayer determined by the Secretary to be affected by a Presidentially declared disaster (as defined by section 1033(h)(3)), the Secretary may prescribe regulations under which a period of up to 90 days may be disregarded in determining, under the internal revenue laws, in respect of any tax liability (including any penalty, additional amount, or addition to the tax) of such taxpayer—

"(1) whether any of the acts by the taxpayer described in paragraph (1) of section 7508(a) were performed within the time prescribed therefor, and

"(2) the amount of any credit or refund.

"(b) INTEREST ON OVERPAYMENTS AND UNDERPAYMENTS.—Subsection (a) shall not apply for the purpose of determining interest on any overpayment or underpayment."

(b) CLERICAL AMENDMENT.—The table of sections for chapter 77 is amended by inserting after the item relating to section 7508 the following new item:

"Sec. 7508A. Authority to postpone certain tax-related deadlines by reason of presidentially declared disaster."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to any period for performing an act that has not expired before the date of the enactment of this Act.

SEC. 922. USE OF CERTAIN APPRAISALS TO ESTABLISH AMOUNT OF DISASTER LOSS.

(a) IN GENERAL.—Subsection (i) of section 165 is amended by adding at the end the following new paragraph:

"(4) USE OF DISASTER LOAN APPRAISALS TO ESTABLISH AMOUNT OF LOSS.—Nothing in this title shall be construed to prohibit the Secretary from prescribing regulations or other guidance under which an appraisal for the purpose of obtaining a loan of Federal funds or a loan guarantee from the Federal Government as a result of a Presidentially declared disaster (as defined by section 1033(h)(3)) may be used to establish the amount of any loss described in paragraph (1) or (2)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 923. TREATMENT OF LIVESTOCK SOLD ON ACCOUNT OF WEATHER-RELATED CONDITIONS.

(a) DEFERRAL OF INCOME INCLUSION.—Subsection (e) of section 451 (relating to special rules for proceeds from livestock sold on account of drought) is amended—

(1) by striking "drought conditions, and that these drought conditions" in paragraph (1) and inserting "drought, flood, or other weather-related conditions, and that such conditions"; and

(2) by inserting ", FLOOD, OR OTHER WEATHER-RELATED CONDITIONS" after "DROUGHT" in the subsection heading.

(b) INVOLUNTARY CONVERSIONS.—Subsection (e) of section 1033 (relating to livestock sold on account of drought) is amended—

(1) by inserting ", flood, or other weather-related conditions" before the period at the end thereof; and

(2) by inserting ", FLOOD, OR OTHER WEATHER-RELATED CONDITIONS" after "DROUGHT" in the subsection heading.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales and exchanges after December 31, 1996.

SEC. 924. MORTGAGE FINANCING FOR RESIDENCES LOCATED IN DISASTER AREAS.

Subsection (k) of section 143 (relating to mortgage revenue bonds; qualified mortgage bond and qualified veteran's mortgage bond) is amended by adding at the end the following new paragraph:

"(11) SPECIAL RULES FOR RESIDENCES LOCATED IN DISASTER AREAS.—In the case of a residence located in an area determined by the President to warrant assistance from the Federal Government under the Disaster Relief and Emergency Assistance Act (as in effect on the date of the enactment of the Revenue Reconciliation Act of 1997), this section shall be applied with the following modifications to financing provided with respect to such residence within 1 year after the date of the disaster declaration:

"(A) Subsection (d) (relating to 3-year requirement) shall not apply.

"(B) Subsections (e) and (f) (relating to purchase price requirement and income requirement) shall be applied as if such residence were a targeted area residence.

The preceding sentence shall apply only with respect to bonds issued after December 31, 1996, and before January 1, 2000."

Subtitle D—Provisions Relating to Employment Taxes

SEC. 931. CLARIFICATION OF EMPLOYMENT TAX STATUS OF INDIVIDUALS DISTRIBUTING BAKERY PRODUCTS.

(a) INTERNAL REVENUE CODE.—Subparagraph (A) of section 3121(d)(3) is amended by striking "bakery products,".

(b) SOCIAL SECURITY ACT.—Subparagraph (A) of section 210(j)(3) of the Social Security Act is amended by striking "bakery products,".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to services performed after December 31, 1997.

SEC. 932. CLARIFICATION OF STANDARD TO BE USED IN DETERMINING EMPLOYMENT TAX STATUS OF SECURITIES BROKERS.

(a) IN GENERAL.—In determining for purposes of the Internal Revenue Code of 1986 whether a registered representative of a securities broker-dealer is an employee (as defined in section 3121(d) of the Internal Revenue Code of 1986), no weight shall be given to instructions from the service recipient which are imposed only in compliance with investor protection standards imposed by the Federal Government, any State government, or a governing body pursuant to a delegation by a Federal or State agency.

(b) EFFECTIVE DATE.—Subsection (a) shall apply to services performed after December 31, 1997.

SEC. 933. CLARIFICATION OF EXEMPTION FROM SELF-EMPLOYMENT TAX FOR CERTAIN TERMINATION PAYMENTS RECEIVED BY FORMER INSURANCE SALESMEN.

(a) INTERNAL REVENUE CODE.—Section 1402 (relating to definitions) is amended by adding at the end the following new subsection:

"(k) CODIFICATION OF TREATMENT OF CERTAIN TERMINATION PAYMENTS RECEIVED BY FORMER INSURANCE SALESMEN.—Nothing in subsection (a) shall be construed as including in the net earnings from self-employment of an individual 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 such individual's agreement to perform such services for such company,

"(2) such individual performs no services for such company after such termination and before the close of such taxable year,

"(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

"(4) the amount of such payment—

"(A) depends solely on policies sold by such individual during the last year of such agreement and the extent to which such policies remain in force for some period after such termination, and

"(B) does not depend to any extent on length of service or overall earnings from services performed for such company."

(b) SOCIAL SECURITY ACT.—Section 211 of the Social Security Act is amended by adding at the end the following new subsection:

"Codification of Treatment of Certain Termination Payments Received by Former Insurance Salesmen

"(j) Nothing in subsection (a) shall be construed as including in the net earnings from self-employment of an individual 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 such individual's agreement to perform such services for such company,

"(2) such individual performs no services for such company after such termination and before the close of such taxable year,

"(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

"(4) the amount of such payment—

"(A) depends solely on policies sold by such individual during the last year of such agreement and the extent to which such policies remain in force for some period after such termination, and

"(B) does not depend to any extent on length of service or overall earnings from services performed for such company."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to payments after December 31, 1997.

SEC. 934. STANDARDS FOR DETERMINING WHETHER INDIVIDUALS ARE NOT EMPLOYEES.

(a) IN GENERAL.—Chapter 25 (general provisions relating to employment taxes) is amended by adding after section 3510 the following new section:

"SEC. 3511. STANDARDS FOR DETERMINING WHETHER INDIVIDUALS ARE NOT EMPLOYEES.

"(a) GENERAL RULE.—For purposes of this title, and notwithstanding any provision of this title to the contrary, if the requirements of subsections (b), (c), and (d) are met with respect to any service performed by any individual, then with respect to such service—

"(1) the service provider shall not be treated as an employee,

"(2) the service recipient shall not be treated as an employer, and

"(3) the payor shall not be treated as an employer.

"(b) SERVICE PROVIDER REQUIREMENTS WITH REGARD TO SERVICE RECIPIENT.—For the purposes of subsection (a), the requirements of this subsection are met if the service provider, in connection with performing the service—

"(1) has a significant investment in assets and/or training,

"(2) incurs significant unreimbursed expenses,

"(3) agrees to perform the service for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause,

"(4) is paid primarily on a commissioned basis, or

"(5) purchases products for resale.

"(c) ADDITIONAL SERVICE PROVIDER REQUIREMENTS WITH REGARD TO OTHERS.—For the purposes of subsection (a), the requirements of this subsection are met if—

"(1) the service provider—

"(A) has a principal place of business,

"(B) does not primarily provide the service in the service recipient's place of business, or

"(C) pays a fair market rent for use of the service recipient's place of business; or

"(2) the service provider—

"(A) is not required to perform service exclusively for the service recipient, and

"(B) in the year involved, or in the preceding or subsequent year—

"(i) has performed a significant amount of service for other persons,

"(ii) has offered to perform service for other persons through—

"(I) advertising,

"(II) individual written or oral solicitations,

"(III) listing with registries, agencies, brokers, and other persons in the business of providing referrals to other service recipients, or

"(IV) other similar activities, or

"(iii) provides service under a business name which is registered with (or for which a license has been obtained from) a State, a political subdivision of a State, or any agency or instrumentality of 1 or more States or political subdivisions.

"(d) WRITTEN DOCUMENT REQUIREMENTS.—For purposes of subsection (a), the requirements of this subsection are met if the services performed by the individual are performed pursuant to a written contract between such individual and the person for whom the services are performed, or the payor, and such contract provides that the individual will not be treated as an employee with respect to such services for purposes of this subtitle or subtitle A.

"(e) SPECIAL RULES.—For purposes of this section—

"(1) If for any taxable year any service recipient or payor fails to meet the applicable reporting requirements of sections 6041(a), 6041A(a), or 6051 with respect to a service provider, then, unless such failure is due to reasonable cause and not willful neglect, this section shall not apply in determining whether such service provider shall not be treated as an employee of such service recipient or payor for such year.

"(2) If the service provider is performing services through an entity owned in whole or in part by such service provider, then the references to 'service provider' in subsections (b) through (d) may include such entity, provided that the written contract referred to in paragraph (1) of subsection (d) may be with either the service provider or such entity and need not be with both.

"(f) DEFINITIONS.—For the purposes of this section—

"(1) SERVICE PROVIDER.—The term 'service provider' means any individual who performs service for another person.

"(2) SERVICE RECIPIENT.—Except as provided in paragraph (5), the term 'service recipient' means the person for whom the service provider performs such service.

"(3) PAYOR.—Except as provided in paragraph (5), the term 'payor' means the person who pays the service provider for the performance of such service in the event that the service recipients do not pay the service provider.

"(4) IN CONNECTION WITH PERFORMING THE SERVICE.—The term 'in connection with performing the service' means in connection or related to—

"(A) the actual service performed by the service provider for the service recipients or for other persons for whom the service provider has performed similar service, or

"(B) the operation of the service provider's trade or business.

"(5) EXCEPTIONS.—The terms 'service recipient' and 'payor' do not include any entity which is owned in whole or in part by the service provider."

(b) CLERICAL AMENDMENT.—The table of sections for chapter 25 is amended by adding at the end the following new item:

"Sec. 3511. Standards for determining whether individuals are not employees."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to services performed after December 31, 1997.

Subtitle E—Provisions Relating to Small Businesses

SEC. 941. WAIVER OF PENALTY THROUGH 1998 ON SMALL BUSINESSES FAILING TO MAKE ELECTRONIC FUND TRANSFERS OF TAXES.

No penalty shall be imposed under the Internal Revenue Code of 1986 solely by reason of a failure by a person to use the electronic fund transfer system established under section 6302(h) of such Code if—

(1) such person is a member of a class of taxpayers first required to use such system on or after July 1, 1997, and

(2) such failure occurs before January 1, 1999.

SEC. 942. CLARIFICATION OF TREATMENT OF HOME OFFICE USE FOR ADMINISTRATIVE AND MANAGEMENT ACTIVITIES.

(a) IN GENERAL.—Paragraph (1) of section 280A(c) is amended by adding at the end the following new sentence: "For purposes of subparagraph (A), the term 'principal place of business' includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

Subtitle F—Other Provisions

SEC. 951. USE OF ESTIMATES OF SHRINKAGE FOR INVENTORY ACCOUNTING.

(a) IN GENERAL.—Section 471 (relating to general rule for inventories) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) ESTIMATES OF INVENTORY SHRINKAGE PERMITTED.—A method of determining inventories shall not be deemed not to clearly reflect income solely because it utilizes estimates of inventory shrinkage that are confirmed by a physical count only after the last day of the taxable year if—

"(1) the taxpayer normally does a physical count of inventories at each location on a regular and consistent basis, and

"(2) the taxpayer makes proper adjustments to such inventories and to its estimating methods to the extent such estimates are greater than or less than the actual shrinkage."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by this section shall apply to taxable years ending after the date of the enactment of this Act.

(2) COORDINATION WITH SECTION 481.—In the case of any taxpayer permitted by this section to change its method of accounting to a permissible method for any taxable year—

(A) such changes shall be treated as initiated by the taxpayer,

(B) such changes shall be treated as made with the consent of the Secretary, and

(C) the period for taking into account the adjustments under section 481 by reason of such change shall be 4 years.

SEC. 952. ASSIGNMENT OF WORKMEN'S COMPENSATION LIABILITY ELIGIBLE FOR EXCLUSION RELATING TO PERSONAL INJURY LIABILITY ASSIGNMENTS.

(a) IN GENERAL.—Subsection (c) of section 130 (relating to certain personal injury liability assignments) is amended—

(1) by inserting ", or as compensation under any workmen's compensation act," after "(whether by suit or agreement)" in the material preceding paragraph (1),

(2) by inserting "or the workmen's compensation claim," after "agreement," in paragraph (1), and

(3) by striking "section 104(a)(2)" in paragraph (2)(D) and inserting "paragraph (1) or (2) of section 104(a)".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to claims under workmen's compensation acts filed after the date of the enactment of this Act.

SEC. 953. TAX-EXEMPT STATUS FOR CERTAIN STATE WORKER'S COMPENSATION ACT COMPANIES.

(a) IN GENERAL.—Section 501(c)(27) (relating to membership organizations under workmen's compensation acts) is amended by adding at the end the following:

"(B) Any organization (including a mutual insurance company) if—

"(i) such organization is created by State law and is organized and operated under State law exclusively to—

"(I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and

"(II) provide related coverage which is incidental to workmen's compensation insurance,

"(ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements relating thereto,

"(iii)(I) the State makes a financial commitment with respect to such organization either by extending the full faith and credit of the State to debt of such organization or by providing the initial operating capital of such organization and (II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution, and

"(iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both."

(b) CONFORMING AMENDMENTS.—Section 501(c)(27) of such Code is amended by inserting "(A)" after "(27)", by redesignating subparagraphs (A), (B), and (C) as clauses (i), (ii), and (iii), respectively, and by redesignating clauses (i) and (ii) of subparagraphs (B) and (C) (before redesignation) as subclauses (I) and (II), respectively.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 954. ELECTION TO CONTINUE EXCEPTION FROM TREATMENT OF PUBLICLY TRADED PARTNERSHIPS AS CORPORATIONS.

(a) IN GENERAL.—Section 7704 is amended by adding at the end thereof the following new subsection:

"(g) EXCEPTION FOR EXISTING PUBLICLY TRADED PARTNERSHIPS.—

"(1) IN GENERAL.—Subsection (a) shall not apply to an existing publicly traded partnership which elects the application of this subsection and consents to the application of the tax imposed by paragraph (3).

"(2) EXISTING PUBLICLY TRADED PARTNERSHIP.—For purposes of this section, the term 'existing publicly traded partnership' means any publicly traded partnership to which subsection (a) does not apply as of the date of the enactment of this paragraph (other than by reason of subsection (c)(1)).

"(3) ADDITIONAL TAX ON ELECTING PUBLICLY TRADED PARTNERSHIPS.—

"(A) IMPOSITION OF TAX.—There is hereby imposed for each taxable year on the income of every electing publicly traded partnership a tax equal to 15 percent of the gross income for such taxable year from the active conduct of trades and businesses by the partnership.

"(B) ELECTING PUBLICLY TRADED PARTNERSHIP.—For purposes of this paragraph, the term 'electing publicly traded partnership' means any partnership for which the consent under paragraph (1) is in effect.

"(C) ADJUSTMENTS IN THE CASE OF TIERED PARTNERSHIPS.—For purposes of this paragraph, if the income of the partnership includes its distributive share of income from another partnership for any taxable year, the gross income referred to in subparagraph (A) shall include the gross income of such other partnership from the active conduct of trades and businesses of such other partnership (in lieu of such distributive share). A similar rule shall apply in the case of lower-tiered partnerships.

"(D) TREATMENT OF TAX.—For purposes of this title, the tax imposed by this paragraph shall be treated as imposed by chapter 1 other than for purposes of determining the amount of any credit allowable under chapter 1.

"(4) ELECTION.—An election and consent under this subsection shall apply to the taxable year for which made and all subsequent taxable years unless revoked by the partnership. Such revocation may be made without the consent of the Secretary, but, once so revoked, may not be reinstated.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 955. EXCLUSION FROM UNRELATED BUSINESS TAXABLE INCOME FOR CERTAIN SPONSORSHIP PAYMENTS.

(a) IN GENERAL.—Section 513 (relating to unrelated trade or business income) is amended by adding at the end the following new subsection:

"(i) TREATMENT OF CERTAIN SPONSORSHIP PAYMENTS.—

"(1) IN GENERAL.—The term 'unrelated trade or business' does not include the activity of soliciting and receiving qualified sponsorship payments.

"(2) QUALIFIED SPONSORSHIP PAYMENTS.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified sponsorship payment' means any payment made by any person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo (or product lines) of such person's trade or business in connection with the activities of the organization that receives such payment. Such a use or acknowledgement does not include advertising such person's products or services (including messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use such products or services).

"(B) LIMITATIONS.—

"(i) CONTINGENT PAYMENTS.—The term 'qualified sponsorship payment' does not include any payment if the amount of such payment is contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events.

"(ii) ACKNOWLEDGEMENTS OR ADVERTISING IN PERIODICALS.—The term 'qualified sponsorship payment' does not include any payment which entitles the payor to an acknowledgement or advertising in 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 specific event conducted by the payee organization.

"(3) ALLOCATION OF PORTIONS OF SINGLE PAYMENT.—For purposes of this subsection, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of such payment and the other portion of such payment shall be treated as separate payments.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments solicited or received after December 31, 1997.

SEC. 956. ASSOCIATIONS OF HOLDERS OF TIMESHARE INTERESTS TO BE TAXED LIKE OTHER HOMEOWNERS ASSOCIATIONS.

(a) TIMESHARE ASSOCIATIONS INCLUDED AS HOMEOWNER ASSOCIATIONS.—

(1) IN GENERAL.—Paragraph (1) of section 528(c) (defining homeowners association) is amended—

(A) by striking "or a residential real estate management association" and inserting ", a residential real estate management association, or a timeshare association" in the material preceding subparagraph (A),

(B) by striking "or" at the end of clause (i) of subparagraph (B), by striking the period at the end of clause (ii) of subparagraph (B) and inserting ", or", and by adding at the end of subparagraph (B) the following new clause:

"(iii) owners of timeshare rights to use, or timeshare ownership interests in, association property in the case of a timeshare association,", and

(C) by inserting "and, in the case of a timeshare association, for activities provided to or on behalf of members of the association" before the comma at the end of subparagraph (C).

(2) TIMESHARE ASSOCIATION DEFINED.—Subsection (c) of section 528 is amended by redesignating paragraph (4) as paragraph (5) and by inserting after paragraph (3) the following new paragraph:

"(4) TIMESHARE ASSOCIATION.—The term 'timeshare association' means any organization (other than a condominium management association) meeting the requirement of subparagraph (A) of paragraph (1) if any member thereof holds a timeshare right to use, or a timeshare ownership interest in, real property constituting association property."

(b) EXEMPT FUNCTION INCOME.—Paragraph (3) of section 528(d) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by adding at the end the following new subparagraph:

"(C) owners of timeshare rights to use, or timeshare ownership interests in, real property in the case of a timeshare association."

(c) RATE OF TAX.—Subsection (b) of section 528 (relating to certain homeowners associations) is amended by inserting before the period "(32 percent of such income in the case of a timeshare association)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1996.

SEC. 957. ADDITIONAL ADVANCE REFUNDING OF CERTAIN VIRGIN ISLAND BONDS.

Subclause (I) of section 149(d)(3)(A)(i) of the Internal Revenue Code of 1986 shall not apply to the second advance refunding of any issue of the Virgin Islands which was first advance refunded before June 9, 1997, if the debt provisions of the refunding bonds are changed to repeal the priority first lien requirement of the refunded bonds.

SEC. 958. NONRECOGNITION OF GAIN ON SALE OF STOCK TO CERTAIN FARMERS' COOPERATIVES.

(a) IN GENERAL.—Section 1042 (relating to sales of stock to employee stock ownership plans or certain cooperatives) is amended by adding at the end the following new subsection:

"(g) APPLICATION OF SECTION TO SALES OF STOCK IN AGRICULTURAL REFINERS AND PROCESSORS TO ELIGIBLE FARM COOPERATIVES.—

"(1) In general.—This section shall apply to the sale of stock of a qualified refiner or processor to an eligible farmers' cooperative.

"(2) Qualified refiner or processor.—For purposes of this subsection, the term 'qualified refiner or processor' means a domestic corporation—

"(A) 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

"(B) which purchases more than one-half of such products to be refined or processed from—

"(i) farmers who make up the eligible farmers' cooperative which is purchasing stock in the corporation in a transaction to which this subsection is to apply, and

"(ii) such cooperative.

"(3) Eligible farmers' cooperative.—For purposes of this section, the term 'eligible farmers' cooperative' means an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products.

"(4) Special rules.—In applying this section to a sale to which paragraph (1) applies—

"(A) the eligible farmers' cooperative shall be treated in the same manner as a cooperative described in subsection (b)(1)(B),

"(B) subsection (b)(2) shall be applied by substituting '100 percent' for '30 percent' each place it appears,

"(C) the determination as to whether any stock in the domestic corporation is a qualified security shall be made without regard to whether the stock is an employer security or to subsection (c)(1)(A), and

"(D) paragraphs (2)(D) and (7) of subsection (c) shall not apply."

(b) Effective Date.—The amendment made by this section shall apply to sales after December 31, 1997.

SEC. 959. EXCEPTION FROM REPORTING OF REAL ESTATE TRANSACTIONS FOR SALES AND EXCHANGES OF CERTAIN PRINCIPAL RESIDENCES.

(a) In General.—Subsection (e) of section 6045 (relating to return required in the case of real estate transactions) is amended by adding at the end the following new paragraph:

"(5) Exception for sales or exchanges of certain principal residences.—

"(A) In general.—Paragraph (1) shall not apply to any sale or exchange of a residence for $250,000 or less if the person referred to in paragraph (2)(A) receives written assurance in a form acceptable to the Secretary from the seller that—

"(i) such residence is the principal residence (within the meaning of section 121) of the seller,

"(ii) there is no federally subsidized mortgage financing assistance with respect to the mortgage on such residence, and "(iii) the seller meets the requirements of section 121(a) with respect to such sale or exchange.

If such assurance includes an assurance that the seller is married, the preceding sentence shall be applied by substituting '$500,000' for '$250,000'.

"(B) SELLER.—For purposes of this paragraph, the term 'seller' includes the person relinquishing the residence in an exchange."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to sales and exchanges after the date of the enactment of this Act.

SEC. 960. INCREASED DEDUCTIBILITY OF BUSINESS MEAL EXPENSES FOR INDIVIDUALS SUBJECT TO FEDERAL HOURS OF SERVICE.

(a) IN GENERAL.—Section 274(n) (relating to only 50 percent of meal and entertainment expenses allowed as deduction) is amended by adding at the end the following new paragraph:

"(3) SPECIAL RULE FOR INDIVIDUALS SUBJECT TO FEDERAL HOURS OF SERVICE.—

"(A) IN GENERAL.—In the case of any expenses for food or beverages consumed while away from home (within the meaning of section 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of service limitations of the Department of Transportation, paragraph (1) shall be applied by substituting 'the applicable percentage' for '50 percent'.

"(B) APPLICABLE PERCENTAGE.—For purposes of this paragraph, the term 'applicable percentage' means the percentage determined under the following table:

"For taxable years beginning in calendar year—	The applicable percentage is—
1998 or 1999	55
2000 or 2001	60
2002 or 2003	65
2004 or 2005	70
2006 or 2007	75
2008 or thereafter	80."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

SEC. 961. QUALIFIED LESSEE CONSTRUCTION ALLOWANCES FOR SHORT-TERM LEASES.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 is amended by inserting after section 109 the following new section:

"SEC. 110. QUALIFIED LESSEE CONSTRUCTION ALLOWANCES FOR SHORT-TERM LEASES.

"(a) IN GENERAL.—Gross income of a lessee does not include any amount received in cash (or treated as a rent reduction) by a lessee from a lessor—

"(1) under a short-term lease of retail space, and

"(2) for the purpose of such lessee's constructing or improving qualified long-term real property for use in such lessee's trade or business at such retail space, but only to the extent that such amount does not exceed the amount expended by the lessee for such construction or improvement.

"(b) CONSISTENT TREATMENT BY LESSOR.—Qualified long-term real property constructed or improved in connection with any amount excluded from a lessee's income by reason of subsection (a) shall be treated as nonresidential real property by the lessor.

"(c) DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED LONG-TERM REAL PROPERTY.—The term 'qualified long-term real property' means nonresidential real property which is part of, or otherwise present at, the retail space referred to in subsection (a) and which reverts to the lessor at the termination of the lease.

"(2) SHORT-TERM LEASE.—The term 'short-term lease' means a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined under the rules of section 168(i)(3)).

"(3) RETAIL SPACE.—The term 'retail space' means real property leased, occupied, or otherwise used by a lessee in its trade or business of selling tangible personal property or services to the general public.

"(d) INFORMATION REQUIRED TO BE FURNISHED TO SECRETARY.—Under regulations, the lessee and lessor described in subsection (a) shall, at such times and in such manner as may be provided in such regulations, furnish to the Secretary—

"(1) information concerning the amounts received (or treated as a rent reduction) and expended as described in subsection (a), and

"(2) any other information which the Secretary deems necessary to carry out the provisions of this section."

(b) TREATMENT AS INFORMATION RETURN.—Subparagraph (A) of section 6724(d)(1)(A) is amended by striking "or" at the end of clause (vii), by adding "or" at the end of clause (viii), and by adding at the end the following new clause:

"(ix) section 110(d) (relating to qualified lessee construction allowances for short-term leases),".

(c) CROSS REFERENCE.—Paragraph (8) of section 168(i) (relating to treatment of leasehold improvements) is amended by adding at the end the following new subparagraph:

"(C) CROSS REFERENCE.—

"For treatment of qualified long-term real property constructed or improved in connection with cash or rent reduction from lessor to lessee, see section 110(b)."

(d) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by inserting after the item relating to section 109 the following new item:

"Sec. 110. Qualified lessee construction allowances for short-term leases."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to leases entered into after the date of the enactment of this Act.

SEC. 962. TAX TREATMENT OF CONSOLIDATIONS OF LIFE INSURANCE DEPARTMENTS OF MUTUAL SAVINGS BANKS.

(a) GENERAL RULE.—Section 594 (relating to alternative tax for mutual savings banks conducting life insurance business) is amended by adding at the end thereof the following new subsection:

"(c) TREATMENT OF CONSOLIDATIONS.—If 2 or more life insurance departments to which subsection (a) applied are consolidated into a single life insurance company pursuant to a requirement of State law—

"(1) such consolidation shall be treated as a reorganization described in section 368(a)(1)(E), and

"(2) any payments required to be made to policyholders in connection with such consolidation shall be treated as policyholder dividends deductible under section 808 but only if—

"(A) such payments are only with respect to policies in effect immediately before such consolidation,

"(B) such payments are only with respect to policies which are participating before and after such consolidation,

"(C) such payments shall cease with respect to any policy if such policy lapses after such consolidation,

"(D) the policyholders before such consolidation had no divisible right to the surplus of any such department and had no right to vote, and

"(E) the approval of such policyholders was not required for such consolidation."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on December 31, 1991.

SEC. 963. OFFSET OF PAST-DUE, LEGALLY ENFORCEABLE STATE TAX OBLIGATIONS AGAINST OVERPAYMENTS.

(a) IN GENERAL.—Section 6402 is amended by redesignating subsections (e) through (i) as subsections (f) through (j), respectively, and by inserting after subsection (d) the following new subsection:

"(e) COLLECTION OF PAST-DUE, LEGALLY ENFORCEABLE STATE TAX OBLIGATIONS.—

"(1) IN GENERAL.—Upon receiving notice from any State that a named person owes a past-due, legally enforceable State tax obligation to such State, the Secretary shall, under such conditions as may be prescribed by the Secretary—

"(A) reduce the amount of any overpayment payable to such person by the amount of such State tax obligation;

"(B) pay the amount by which such overpayment is reduced under subparagraph (A) to such State and notify such State of such person's name, taxpayer identification number, address, and the amount collected; and

"(C) notify the person making such overpayment that the overpayment has been reduced by an amount necessary to satisfy a past-due, legally enforceable State tax obligation.

If an offset is made pursuant to a joint return, the notice under subparagraph (B) shall include the names, taxpayer identification numbers, and addresses of each person filing such return.

"(2) OFFSET PERMITTED ONLY AGAINST RESIDENTS OF STATE SEEKING OFFSET.—Paragraph (1) shall apply to an overpayment by any person for a taxable year only if the address shown on the return for such taxable year is an address within the State seeking the offset.

"(3) PRIORITIES FOR OFFSET.—Any overpayment by a person shall be reduced pursuant to this subsection—

"(A) after such overpayment is reduced pursuant to—

"(i) subsection (a) with respect to any liability for any internal revenue tax on the part of the person who made the overpayment,

"(ii) subsection (c) with respect to past-due support, and

"(iii) subsection (d) with respect to any past-due, legally enforceable debt owed to a Federal agency, and

"(B) before such overpayment is credited to the future liability for any Federal internal revenue tax of such person pursuant to subsection (b).

If the Secretary receives notice from 1 or more agencies of the State of more than 1 debt subject to paragraph (1) that is owed by such person to such an agency, any overpayment by such person shall be applied against such debts in the order in which such debts accrued.

"(4) NOTICE; CONSIDERATION OF EVIDENCE.—No State may take action under this subsection until such State—

"(A) notifies the person owing the past-due State tax liability that the State proposes to take action pursuant to this section,

"(B) gives such person at least 60 days to present evidence that all or part of such liability is not past-due or not legally enforceable,

"(C) considers any evidence presented by such person and determines that an amount of such debt is past-due and legally enforceable, and

"(D) satisfies such other conditions as the Secretary may prescribe to ensure that the determination made under subparagraph (C) is valid and that the State has made reasonable efforts to obtain payment of such State tax obligation.

"(5) PAST-DUE, LEGALLY ENFORCEABLE STATE TAX OBLIGATION.—For purposes of this subsection, the term 'past-due, legally enforceable State tax obligation' means a debt—

"(A)(i) which resulted from—

"(I) a judgment rendered by a court of competent jurisdiction which has determined an amount of State tax to be due, or

"(II) a determination after an administrative hearing which has determined an amount of State tax to be due, and

"(ii) which is no longer subject to judicial review, or

"(B) which resulted from a State tax which has been assessed but not collected, the time for redetermination of which has expired, and which has not been delinquent for more than 10 years.

For purposes of this paragraph, the term 'State tax' includes any local tax administered by the chief tax administration agency of the State.

"(6) REGULATIONS.—The Secretary shall issue regulations prescribing the time and manner in which States must submit notices of past-due, legally enforceable State tax obligations and the necessary information that must be contained in or accompany such notices. The regulations shall specify the types of State taxes and the minimum amount of debt to which the reduction procedure established by paragraph (1) may be applied. The regulations may require States to pay a fee to reimburse the Secretary for the cost of applying such procedure. Any fee paid to the Secretary pursuant to the preceding sentence shall be used to reimburse appropriations which bore all or part of the cost of applying such procedure.

"(7) ERRONEOUS PAYMENT TO STATE.—Any State receiving notice from the Secretary that an erroneous payment has been made to such State under paragraph (1) shall pay promptly to the Secretary, in accordance with such regulations as the Secretary may prescribe, an amount equal to the amount of such erroneous payment (without regard to whether any other amounts payable to such State under such paragraph have been paid to such State)."

(b) DISCLOSURE OF CERTAIN INFORMATION TO STATES REQUESTING REFUND OFFSETS FOR PAST-DUE, LEGALLY ENFORCEABLE STATE TAX OBLIGATIONS.—

(1) Paragraph (10) of section 6103(l) is amended by striking "(c) or (d)" each place it appears and inserting "(c), (d), or (e)".

(2) The paragraph heading for such paragraph (10) is amended by striking "SECTION 6402(c) OR 6402(d)" and inserting "SUBSECTION (c), (d), OR (e) OF SECTION 6402".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (a) of section 6402 is amended by striking "(c) and (d)" and inserting "(c), (d), and (e)".

(2) Paragraph (2) of section 6402(d) is amended by striking "and before such overpayment" and inserting "and before such overpayment is reduced pursuant to subsection (e) and before such overpayment".

(3) Subsection (f) of section 6402, as redesignated by subsection (a), is amended—

(A) by striking "(c) or (d)" and inserting "(c), (d), or (e)", and

(B) by striking "Federal agency" and inserting "Federal agency or State".

(4) Subsection (h) of section 6402, as redesignated by subsection (a), is amended by striking "subsection (c)" and inserting "subsection (c) or (e)".

(d) AMENDMENTS APPLIED AFTER TECHNICAL CORRECTIONS TO PERSONAL RESPONSIBILITY AND WORK OPPORTUNITY RECONCILIATION ACT OF 1996.—

(1) Section 110(l) of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 is amended by striking paragraphs (4), (5), and (7) (and the amendments made by such paragraphs), and the Internal Revenue Code of 1986 shall

be applied as if such paragraphs (and amendments) had never been enacted.

(2) For purposes of applying the amendments made by this section other than this subsection, the provisions of this subsection shall be treated as having been enacted immediately before the other provisions of this section.

(e) EFFECTIVE DATE.—The amendments made by this section (other than subsection (d)) shall apply to refunds payable under section 6402 of the Internal Revenue Code of 1986 after December 31, 1998.

SEC. 964. EXEMPTION OF THE INCREMENTAL COST OF A CLEAN FUEL VEHICLE FROM THE LIMITS ON DEPRECIATION FOR VEHICLES.

(a) IN GENERAL.—Section 280F(a)(1) (relating to limiting depreciation on luxury automobiles) is amended by adding at the end the following new subparagraph:

"(C) SPECIAL RULE FOR CERTAIN CLEAN-FUEL PASSENGER AUTOMOBILES.—

"(i) MODIFIED AUTOMOBILES.—In the case of a passenger automobile which is propelled by a fuel which is not a clean-burning fuel to which is installed qualified clean-fuel vehicle property (as defined in section 179A(c)(1)(A)) for purposes of permitting such vehicle to be propelled by a clean burning fuel (as defined in section 179A(e)(1)), subparagraph (A) shall not apply to the cost of the installed qualified clean burning vehicle property as depreciated pursuant to section 168 by applying the rules under subsections (b)(1), (d)(1), and (e)(3)(B) thereof.

"(ii) PURPOSE BUILT PASSENGER VEHICLES.—In the case of a purpose built passenger vehicle (as defined in section 4001(a)(2)(C)(ii)), each of the annual limitations specified in subparagraph (A) shall be tripled."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to property placed in service on or after the date of enactment of this Act and before January 1, 2005.

SEC. 965. TAX BENEFITS FOR LAW ENFORCEMENT OFFICERS KILLED IN THE LINE OF DUTY.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 138 as section 139 and by inserting after section 137 the following new section:

"SEC. 138. SURVIVOR BENEFITS ATTRIBUTABLE TO SERVICE BY A LAW ENFORCEMENT OFFICER WHO IS KILLED IN THE LINE OF DUTY.

"(a) IN GENERAL.—Gross income shall not include any amount paid as a survivor annuity on account of the death of a law enforcement officer killed in the line of duty—

"(1) if such annuity is provided under a governmental plan which meets the requirements of section 401(a) to the spouse (or a former spouse) of the law enforcement officer or to a child of such officer, and

"(2) to the extent such annuity is attributable to such officer's service as a law enforcement officer.

"(b) EXCEPTIONS.—

"(1) IN GENERAL.—Subsection (a) shall not apply with respect to the death of any law enforcement officer if—

"(A) the death was caused by the intentional misconduct of the officer or by such officer's intention to bring about such officer's death,

"(B) the officer was voluntarily intoxicated (as defined in section 1204 of the Omnibus Crime Control and Safe Streets Act of 1968) at the time of death, or

"(C) the officer was performing such officer's duties in a grossly negligent manner at the time of death.

"(2) EXCEPTION FOR BENEFITS PAID TO CERTAIN INDIVIDUALS.—Subsection (a) shall not apply to any payment to an individual whose actions were a substantial contributing factor to the death of the officer.

"(c) LAW ENFORCEMENT OFFICER.—For purposes of this section, the term 'law enforcement officer' means an individual serving a public agency (as defined in section 1204 of the Omnibus Crime Control and Safe Streets Act of 1968) in an official capacity, with or without compensation, as a law enforcement officer (as defined in such section)."

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 is amended by striking the last item and inserting the following new items:

"Sec. 138. Survivor benefits attributable to service by a law enforcement officer who is killed in the line of duty.
"Sec. 139. Cross references to other Acts."

(c) EFFECTIVE DATE.—The amendments made by this subsection shall apply to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after such date.

SEC. 966. TEMPORARY SUSPENSION OF TAXABLE INCOME LIMIT ON PERCENTAGE DEPLETION FOR MARGINAL PRODUCTION.

In the case of taxable years beginning after December 31, 1997, and before January 1, 2000, paragraph (1) of section 613A(d) of the Internal Revenue Code of 1986 shall not apply to so much of the allowance for depletion computed under section 613A(c) of such Code as is attributable to paragraph (6) thereof.

Subtitle G—Extension of Duty-Free Treatment Under Generalized System of Preferences; Tariff Treatment of Certain Equipment and Repair of Vessels

SEC. 971. GENERALIZED SYSTEM OF PREFERENCES.

(a) EXTENSION OF DUTY-FREE TREATMENT UNDER SYSTEM.—Section 505 of the Trade Act of 1974 (19 U.S.C. 2465) is amended by striking "May 31, 1997" and inserting "May 31, 1999".

(b) RETROACTIVE APPLICATION FOR CERTAIN LIQUIDATIONS AND RELIQUIDATIONS.—

(1) IN GENERAL.—Notwithstanding section 514 of the Tariff Act of 1930 or any other provision of law and subject to paragraph (2), the entry—

(A) of any article to which duty-free treatment under title V of the Trade Act of 1974 would have applied if the entry had been made on May 31, 1997, and

(B) that was made after May 31, 1997, and before the date of the enactment of this Act,

shall be liquidated or reliquidated as free of duty, and the Secretary of the Treasury shall refund any duty paid with respect to such entry. As used in this subsection, the term "entry" includes a withdrawal from warehouse for consumption.

(2) REQUESTS.—Liquidation or reliquidation may be made under paragraph (1) with respect to an entry only if a request therefor is filed with the Customs Service, within 180 days after the date of the enactment of this Act, that contains sufficient information to enable the Customs Service—

(A) to locate the entry; or

(B) to reconstruct the entry if it cannot be located.

SEC. 972. EQUIPMENT AND REPAIR OF VESSELS.

(a) TARIFF TREATMENT.—Section 466 of the Tariff Act of 1930 (19 U.S.C. 1466), is amended by adding at the end the following new subsection:

"(i)(1) The duty imposed by subsection (a) shall not apply with respect to activities occurring in a Shipbuilding Agreement Party, with respect to—

"(A) self-propelled seagoing vessels of 100 gross tons or more that are used for transportation of goods or persons or for performance of a specialized service (including, but not limited to, ice breakers and dredges), and

"(B) tugs of 365 kilowatts or more.

A vessel shall be considered 'self-propelled seagoing' if its permanent propulsion and steering provide it all the characteristics of self-navigability in the high seas.

"(2) As used in this subsection—

"(A) the term 'Shipbuilding Agreement Party' means a state or separate customs territory that is a signatory to the Shipbuilding Agreement; and

"(B) the term 'Shipbuilding Agreement' means The Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry, resulting from negotiations under the auspices of the Organization for Economic Cooperation and Development, and entered into on December 21, 1994.".

(b) APPLICABILITY.—The amendment made by subsection (a) applies only with respect to activities occurring in a Shipbuilding Agreement Party (as defined in section 466(i) of the Tariff Act of 1930) during the 1-year period beginning on the date of the enactment of this Act.

Subtitle H—United States-Caribbean Basin Trade Partnership Act

SEC. 981. SHORT TITLE.

This subtitle may be cited as the "United States-Caribbean Basin Trade Partnership Act".

SEC. 982. FINDINGS AND POLICY.

(a) FINDINGS.—The Congress makes the following findings:

(1) The United States apparel industry is a major component of the United States manufacturing sector of the United States, employing nearly 825,000 people who are located in every State in the country. The United States apparel industry consumes 42 percent of the fabric produced by United States textile mills, which employ more than 650,000 people.

(2) In 1973 the United States apparel industry supplied 88 percent of the garments consumed by Americans, and in 1995 that share fell to less than 50 percent.

(3) Countries in the Western Hemisphere offer the greatest opportunities for increased exports of United States textile and apparel products.

(4) Given the greater propensity of countries located in the Western Hemisphere to use United States components and to purchase United States products compared to other countries, increased trade and economic activity between the United States and countries in the Western Hemisphere will create new jobs in the United States as a result of expanding export opportunities.

(5) The Caribbean Basin Economic Recovery Act represents a permanent commitment by the United States to encourage the development of strong democratic governments and revitalized economies in neighboring countries in the Caribbean Basin.

(6) The economic security of the countries in the Caribbean Basin is potentially threatened by the diversion of investment to Mexico as a result of the North American Free Trade Agreement.

(7) Offering NAFTA equivalent benefits to Caribbean Basin beneficiary countries, pending their eventual accession to the NAFTA or a free trade agreement comparable to the NAFTA, will promote the growth of free enterprise and economic opportunity in the region, and thereby enhance the national security interests of the United States.

(b) POLICY.—It is the policy of the United States—

(1) to assure that the domestic textile and apparel industry remains competitive in the global marketplace by encouraging the formation and expansion of "partnerships" between the textile and apparel industry of the United States and the textile and apparel industry of various countries located in the Western Hemisphere; and

(2) to offer to the products of Caribbean Basin partnership countries tariffs and quota treatment equivalent to that accorded to products of NAFTA countries, and to seek the accession of these partnership countries to the NAFTA or a free

trade agreement comparable to the NAFTA at the earliest possible date, with the goal of achieving full participation in the NAFTA or in a free trade agreement comparable to the NAFTA by all partnership countries by not later than January 1, 2005.

SEC. 983. DEFINITIONS.

As used in this Act:

(1) PARTNERSHIP COUNTRY.—The term "partnership country" means a beneficiary country as defined in section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2702(a)(1)(A)).

(2) NAFTA.—The term "NAFTA" means the North American Free Trade Agreement entered into between the United States, Mexico, and Canada on December 17, 1992.

(3) TRADE REPRESENTATIVE.—The term "Trade Representative" means the United States Trade Representative.

(4) WTO AND WTO MEMBER.—The terms "WTO" and "WTO member" have the meanings given those terms in section 2 of the Uruguay Round Agreements Act (19 U.S.C. 3501).

SEC. 984. TEMPORARY PROVISIONS TO PROVIDE NAFTA PARITY TO PARTNERSHIP COUNTRIES.

(a) TEMPORARY PROVISIONS.—Section 213(b) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2703(b)) is amended to read as follows:

"(b) IMPORT-SENSITIVE ARTICLES.—

"(1) IN GENERAL.—Subject to paragraphs (2) through (5), the duty-free treatment provided under this title does not apply to—

"(A) textile and apparel articles which are subject to textile agreements;

"(B) footwear not designated at the time of the effective date of this title as eligible articles for the purpose of the generalized system of preferences under title V of the Trade Act of 1974;

"(C) tuna, prepared or preserved in any manner, in airtight containers;

"(D) petroleum, or any product derived from petroleum, provided for in headings 2709 and 2710 of the HTS;

"(E) watches and watch parts (including cases, bracelets and straps), of whatever type including, but not limited to, mechanical, quartz digital, or quartz analog, if such watches or watch parts contain any material which is the product of any country with respect to which HTS column 2 rates of duty apply; or

"(F) articles to which reduced rates of duty apply under subsection (h).

"(2) NAFTA TRANSITION PERIOD TREATMENT OF CERTAIN TEXTILE AND APPAREL ARTICLES.—

"(A) EQUIVALENT TARIFF AND QUOTA TREATMENT.—During the transition period—

"(i) the tariff treatment accorded at any time to any textile or apparel article that originates in the territory of a partnership country shall be identical to the tariff treatment that is accorded at such time under section 2 of the Annex to an article described in the same 8-digit subheading of the HTS that is an originating good of Mexico and is imported into the United States;

"(ii) duty-free treatment under this title shall apply to any textile or apparel article that is imported into the United States from a partnership country and that—

"(I) is assembled in a partnership country, from fabrics wholly formed and cut in the United States from yarns formed in the United States, and is entered—

"(aa) under subheading 9802.00.80 of the HTS; or

"(bb) under chapter 61 or 62 of the HTS if, after such assembly, the article would have qualified for treatment under subheading 9802.00.80 of the HTS, but for the fact the article was subjected to bleaching, dyeing, stone-washing, enzyme-washing, acid-washing, perma-pressing, or similar processes or embroidery; or

"(II) is knit-to-shape in a partnership country from yarns wholly formed in the United States;

"(III) is made from fabric knit in a partnership country from yarns wholly formed in the United States;

"(IV) is cut and assembled in a partnership country from yarns wholly formed in the United States; or

"(V) is identified under subparagraph (C) as a handloomed, handmade, or folklore article of such country and is certified as such by the competent authority of such country; and

"(iii) no quantitative restriction under any bilateral textile agreement may be applied to the importation into the United States of any textile or apparel article that—

"(I) originates in the territory of a partnership country, or

"(II) qualifies for duty-free treatment under subclause (I), (II), (III), (IV), or (V) of clause (ii).

"(B) NAFTA TRANSITION PERIOD TREATMENT OF NON-ORIGINATING TEXTILE AND APPAREL ARTICLES.—

"(i) PREFERENTIAL TARIFF TREATMENT.—Subject to clause (ii), the President may place in effect at any time during the transition period with respect to any textile or apparel article that—

"(I) is a product of a partnership country, but

"(II) does not qualify as a good that originates in the territory of a partnership country,

tariff treatment that is identical to the in-preference-level tariff treatment accorded at such time under Appendix 6.B of the Annex to an article described in the same 8-digit subheading of the HTS that is a product of Mexico and is imported into the United States. For purposes of this clause, the 'in-preference-level tariff treatment' accorded to an article that is a product of Mexico is the rate of duty applied to that article when imported in quantities less than or equal to the quantities specified in Schedule 6.B.1, 6.B.2., or 6.B.3. of the Annex for imports of that article from Mexico into the United States.

"(ii) LIMITATIONS ON CERTAIN ARTICLES.—(I) Tariff treatment under clause (i) may be extended, during any calendar year, to not more than 45,000,000 square meter equivalents of cotton or man-made fiber apparel, to not more than 1,500,000 square meter equivalents of wool apparel, and to not more than 25,000,000 square meter equivalents of goods entered under subheading 9802.00.80 of the HTS.

"(II) Except as provided in subclause (III), the amounts set forth in subclause (I) shall be allocated among the 7 partnership countries with the largest volume of exports to the United States of textile and apparel goods in calendar year 1996, based upon a pro rata share of the volume of textile and apparel goods of each of those 7 countries that entered the United States under subheading 9802.00.80 of the HTS during the first 12 months of the 14-month period ending on the date of the enactment of the United States-Caribbean Basin Trade Partnership Act.

"(III) Five percent of the amounts set forth in subclause (I) shall be allocated among the partnership countries, other than those to which subclause (II) applies, based upon a pro rata share of the exports to the United States of textile and apparel goods of each of those countries during the first 12 months of the 14-month period ending on the date of the enactment of the United States-Caribbean Basin Trade Partnership Act.

"(iii) PRIOR CONSULTATION.—The President may implement the preferential tariff treatment described in clause (i) only after consultation with representatives of the United States textile and apparel industry and other interested parties regarding—

"(I) the specific articles to which such treatment will be extended,

"(II) the annual quantities of such articles that may be imported at the preferential duty rates described in clause (i), and

"(III) the allocation of such annual quantities among beneficiary countries.

"(C) HANDLOOMED, HANDMADE, AND FOLKLORE ARTICLES.—For purposes of subparagraph (A), the Trade Representative shall consult with representatives of the partnership country for the purpose of identifying particular textile and apparel goods that are mutually agreed upon as being handloomed, handmade, or folklore goods of a kind described in section 2.3 (a), (b), or (c) or Appendix 3.1.B.11 of the Annex.

"(D) BILATERAL EMERGENCY ACTIONS.—(i) The President may take—

"(I) bilateral emergency tariff actions of a kind described in section 4 of the Annex with respect to any textile or apparel article imported from a partnership country if the application of tariff treatment under subparagraph (A) to such article results in conditions that would be cause for the taking of such actions under such section 4 with respect to an article described in the same 8-digit subheading of the HTS that is imported from Mexico; or

"(II) bilateral emergency quantitative restriction actions of a kind described in section 5 of the Annex with respect to imports of any textile or apparel article described in subparagraph (B)(i) (I) and (II) if the importation of such article into the United States results in conditions that would be cause for the taking of such actions under such section 5 with respect to a like article that is a product of Mexico.

"(ii) The requirement in paragraph (5) of section 4 of the Annex (relating to providing compensation) shall not be deemed to apply to a bilateral emergency action taken under this subparagraph.

"(iii) For purposes of applying bilateral emergency action under this subparagraph—

"(I) the term 'transition period' in sections 4 and 5 of the Annex shall be deemed to be the period defined in paragraph (5)(D); and

"(II) any requirements to consult specified in section 4 or 5 of the Annex are deemed to be satisfied if the President requests consultations with the partnership country in question and the country does not agree to consult within the time period specified in such section.

"(3) NAFTA TRANSITION PERIOD TREATMENT OF CERTAIN OTHER ARTICLES ORIGINATING IN BENEFICIARY COUNTRIES.—

"(A) EQUIVALENT TARIFF TREATMENT.—

"(i) IN GENERAL.—Subject to clause (ii), the tariff treatment accorded at any time during the transition period to any article referred to in any of subparagraphs (B) through (F) of paragraph (1) that originates in the territory of a partnership country shall be identical to the tariff treatment that is accorded at such time under Annex 302.2 of the NAFTA to an article described in the same 8-digit subheading of the HTS that is an originating good of Mexico and is imported into the United States.

"(ii) EXCEPTION.—Clause (i) does not apply to any article accorded duty-free treatment under U.S. Note 2(b) to subchapter II of chapter 98 of the HTS.

"(B) RELATIONSHIP TO SUBSECTION (h) DUTY REDUCTIONS.—If at any time during the transition period the rate of duty that would (but for action taken under subparagraph (A)(i) in regard to such period) apply with respect to any article under subsection (h) is a rate of duty that is lower than the rate of duty resulting from such action, then such lower rate of duty shall be applied for the purposes of implementing such action.

"(4) CUSTOMS PROCEDURES.—

"(A) IN GENERAL.—

"(i) The obligations under chapter 5 of the NAFTA regarding customs procedures, as such obligations apply to the exporting country, shall apply to importations under paragraphs (2) and (3) of articles from partnership countries.

"(ii) The Secretary of the Treasury shall prescribe regulations that require, as a condition of entry, that any importer of record that claims preferential treatment under paragraph (2) or (3) must comply with requirements similar in all material respects to the requirements of article 502.1 of the NAFTA. The certificate of origin that otherwise would be required under this subparagraph shall not be required in the case of an article imported under paragraph (2) or (3) if such certificate of origin would not be required under article 503 of the NAFTA for a similar importation from Mexico.

"(B) PENALTIES FOR ENGAGING IN TRANSSHIPMENT OR OTHER CUSTOMS FRAUD.—If an exporter is determined under the laws of the United States to have engaged in illegal transshipment of textile or apparel products from a partnership country, then the President shall deny all benefits under this title to such exporter, and any successors of such exporter, for a period of 2 years.

"(C) STUDY BY USTR ON COOPERATION OF OTHER COUNTRIES CONCERNING CIRCUMVENTION.—The Trade Representative, in consultation with the United States Commissioner of Customs, shall conduct a study analyzing the extent to which each partnership country—

"(i) has cooperated fully with the United States, consistent with its domestic laws and procedures, in instances of circumvention or alleged circumvention of existing quotas on imports of textile and apparel goods, to establish necessary relevant facts in the places of import, export, and, where applicable, transshipment, including investigation of circumvention practices, exchanges of documents, correspondence, reports, and other relevant information, to the extent such information is available;

"(ii) has taken appropriate measures, consistent with its domestic laws and procedures, against exporters and importers involved in instances of false declaration concerning fiber content, quantities, description, classification, or origin of textile and apparel goods; and

"(iii) has penalized the individuals and entities involved in any such circumvention, consistent with its domestic laws and procedures, and has worked closely to seek the cooperation of any third country to prevent such circumvention from taking place in that third country.

The Trade Representative shall submit to the Congress, not later than October 1, 1998, a report on the study conducted under this subparagraph.

"(5) DEFINITIONS.—For purposes of this subsection—

"(A) The term 'the Annex' means Annex 300–B of the NAFTA.

"(B) The term 'NAFTA' means the North American Free Trade Agreement entered into between the United States, Mexico, and Canada on December 17, 1992.

"(C) The term 'partnership country' means a beneficiary country.

"(D) The term 'textile or apparel article' means any article referred to in paragraph (1)(A) that is a good listed in Appendix 1.1 of the Annex.

"(E) The term 'transition period' means, with respect to a partnership country, the period that begins on January 1, 1998, and ends on the earlier of—

"(i) December 31, 1998; or

"(ii) the date on which—

"(I) the United States first applies the NAFTA to the partnership country upon its accession to the NAFTA, or

"(II) there enters into force with respect to the United States and the partnership country a free trade agreement comparable to the NAFTA that makes substantial progress in achieving the negotiating objectives set forth in section 108(b)(5) of the North American Free Trade Agreement Implementation Act (19 U.S.C. 3317(b)(5)).

"(F) An article shall be deemed as originating in the territory of a partnership country if the article meets the rules of origin for a good set forth in chapter 4 of the NAFTA, and, in the case of an article described in Appendix 6.A of the Annex, the requirements stated in such Appendix 6.A for such article to be treated as if it were an originating good. In applying such chapter 4 or Appendix 6.A with respect to a partnership country for purposes of this subsection—

"(i) no countries other than the United States and partnership countries may be treated as being Parties to the NAFTA,

"(ii) references to trade between the United States and Mexico shall be deemed to refer to trade between the United States and partnership countries, and

"(iii) references to a Party shall be deemed to refer to the United States or a partnership country, and references to the Parties shall be deemed to refer to any combination of partnership countries or the United States.".

(b) DETERMINATION REGARDING RETENTION OF DESIGNATION.—Section 212(e)(1) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2702(e)) is amended—

(1) by inserting "(A)" after "(1)";

(2) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively;

(3) by adding at the end the following:

"(B)(i) Based on the President's review and analysis described in subsection (f), the President may determine if the preferential treatment under section 213(b) (2) and (3) should be withdrawn, suspended, or limited with respect to any article of a partnership country. Such determination shall be included in the report required by subsection (f).

"(ii) Withdrawal, suspension, or limitation of the preferential treatment under section 213(b) (2) and (3) with respect to a partnership country shall be taken only after the requirements of subsection (a)(2) and paragraph (2) of this subsection have been met.".

(c) REPORTING REQUIREMENTS.—Section 212(f) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2702(f)) is amended to read as follows:

"(f) REPORTING REQUIREMENTS.—Not later than 1 year after the date of the enactment of the United States-Caribbean Basin Trade Partnership Act and at the close of each 3-year period thereafter, the President shall submit to the Congress a complete report regarding the operation of this title, including—

"(1) with respect to subsections (b) and (c) of this section, the results of a general review of beneficiary countries based on the considerations described in such subsections;

"(2) with respect to subsection (c)(4), the degree to which a country follows accepted rules of international trade provided for under the General Agreement on Tariffs and Trade and the World Trade Organization;

"(3) with respect to subsection (c)(9), the extent to which beneficiary countries are providing or taking steps to provide protection of intellectual property rights comparable to the protection provided to the United States in bilateral intellectual property rights agreements;

"(4) with respect to subsection (b)(2) and subsection (c)(5), the extent that beneficiary countries are providing or taking steps to provide protection of investment and investors comparable to the protection provided to the United States in bilateral investment treaties;

"(5) with respect to subsection (c)(3), the extent that beneficiary countries are providing the United States with equitable and reasonable market access in the product sectors for which benefits are provided under this title;

"(6) with respect to subsection (c)(11), the extent that beneficiary countries are cooperating with the United States in administering the provisions of section 213(b); and

"(7) with respect to subsection (c)(8), the extent that beneficiary countries are meeting the internationally recognized worker rights criteria under such subsection.

In the first report under this subsection, the President shall include a review of the implementation of section 213(b), and his analysis of whether the benefits under paragraphs (2) and (3) of such section further the objectives of this title and whether such benefits should be continued.".

(d) CONFORMING AMENDMENT.—Section 213(a)(1) of the Caribbean Basin Economic Recovery Act is amended by inserting "and except as provided in section 213(b)(2) and (3)," after "Tax Reform Act of 1986,".

SEC. 985. EFFECT OF NAFTA ON SUGAR IMPORTS FROM BENEFICIARY COUNTRIES.

The President shall monitor the effects, if any, that the implementation of the NAFTA has on the access of beneficiary countries under the Caribbean Basin Economic Recovery Act to the United States market for sugars, syrups, and molasses. If the President considers that the implementation of the NAFTA is affecting, or will likely affect, in an adverse manner the access of such countries to the United States market, the President shall promptly—

(1) take such actions, after consulting with interested parties and with the appropriate committees of the House of Representatives and the Senate, or

(2) propose to the Congress such legislative actions,

as may be necessary or appropriate to ameliorate such adverse effect.

SEC. 986. DUTY-FREE TREATMENT FOR CERTAIN BEVERAGES MADE WITH CARIBBEAN RUM.

Section 213(a) of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2703(a)) is amended—

(1) in paragraph (5), by striking "chapter" and inserting "title"; and

(2) by adding at the end the following new paragraph:

"(6) Notwithstanding paragraph (1), the duty-free treatment provided under this title shall apply to liqueurs and spirituous beverages produced in the territory of Canada from rum if—

"(A) such rum is the growth, product, or manufacture of a beneficiary country or of the Virgin Islands of the United States;

"(B) such rum is imported directly from a beneficiary country or the Virgin Islands of the United States into the territory of Canada, and such liqueurs and spirituous beverages are imported directly from the territory of Canada into the customs territory of the United States;

"(C) when imported into the customs territory of the United States, such liqueurs and spirituous beverages are classified in subheading 2208.90 or 2208.40 of the HTS; and

"(D) such rum accounts for at least 90 percent by volume of the alcoholic content of such liqueurs and spiritous beverages.".

SEC. 987. MEETINGS OF TRADE MINISTERS AND USTR.

(a) SCHEDULE OF MEETINGS.—The President shall take the necessary steps to convene a meeting with the trade ministers of the partnership countries in order to establish a schedule of regular meetings, to commence as soon as is practicable, of the trade ministers and the Trade Representative, for the purpose set forth in subsection (b).

(b) PURPOSE.—The purpose of the meetings scheduled under subsection (a) is to reach agreement between the United States and partnership countries on the likely timing and procedures for initiating negotiations for partnership to accede to the NAFTA, or to enter into mutually advantageous free trade agreements with the United States that contain provisions comparable to those in the NAFTA and would make substantial progress in achieving the negotiating objectives set forth in section 108(b)(5) of the North American Free Trade Agreement Implementation Act (19 U.S.C. 3317(b)(5)).

SEC. 988. REPORT ON ECONOMIC DEVELOPMENT AND MARKET ORIENTED REFORMS IN THE CARIBBEAN.

(a) IN GENERAL.—The Trade Representative shall make an assessment of the economic development efforts and market oriented reforms in each partnership country and the ability of each such country, on the basis of such efforts and reforms, to undertake the obligations of the NAFTA. The Trade Representative shall, not later than July 1, 1998, submit to the President and to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on that assessment.

(b) ACCESSION TO NAFTA.—

(1) ABILITY OF COUNTRIES TO IMPLEMENT NAFTA.—The Trade Representative shall include in the report under subsection (a) a discussion of possible timetables and procedures pursuant to which partnership countries can complete the economic reforms necessary to enable them to negotiate accession to the NAFTA. The Trade Representative shall also include an assessment of the potential phase-in periods that may be necessary for those partnership countries with less developed economies to implement the obligations of the NAFTA.

(2) FACTORS IN ASSESSING ABILITY TO IMPLEMENT NAFTA.—In assessing the ability of each partnership country to undertake the obligations of the NAFTA, the Trade Representative should consider, among other factors—

(A) whether the country has joined the WTO;

(B) the extent to which the country provides equitable access to the markets of that country;

(C) the degree to which the country uses export subsidies or imposes export performance requirements or local content requirements;

(D) macroeconomic reforms in the country such as the abolition of price controls on traded goods and fiscal discipline;

(E) progress the country has made in the protection of intellectual property rights;

(F) progress the country has made in the elimination of barriers to trade in services;

(G) whether the country provides national treatment to foreign direct investment;

(H) the level of tariffs bound by the country under the WTO (if the country is a WTO member);

(I) the extent to which the country has taken other trade liberalization measures; and

(J) the extent which the country works to accommodate market access objectives of the United States.

(c) PARITY REVIEW IN THE EVENT A NEW COUNTRY ACCEDES TO NAFTA.—If—

(1) a country or group of countries accedes to the NAFTA, or

(2) the United States negotiates a comparable free trade agreement with another country or group of countries,

the Trade Representative shall provide to the committees referred to in subsection (a) a separate report on the economic impact of the new trade relationship on partnership countries. The report shall include any measures the Trade Representative proposes to minimize the potential for the diversion of investment from partnership countries to the new NAFTA member or free trade agreement partner.

TITLE X—REVENUES

Subtitle A—Financial Products

SEC. 1001. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

(a) IN GENERAL.—Part IV of subchapter P of chapter 1 is amended by adding at the end the following new section:

“SEC. 1259. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

“(a) IN GENERAL.—If there is a constructive sale of an appreciated financial position—

“(1) the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date), and

“(2) for purposes of applying this title for periods after the constructive sale—

“(A) proper adjustment shall be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and

“(B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.

“(b) APPRECIATED FINANCIAL POSITION.—For purposes of this section—

“(1) IN GENERAL.—Except as provided in paragraph (2), the term ‘appreciated financial position’ means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value.

"(2) EXCEPTIONS.—The term 'appreciated financial position' shall not include—

"(A) any position with respect to straight debt (as defined in section 1361(c)(5)(B) without regard to clause (iii) thereof), and

"(B) any position which is marked to market under any provision of this title or the regulations thereunder.

"(3) POSITION.—The term 'position' means an interest, including a futures or forward contract, short sale, or option.

"(c) CONSTRUCTIVE SALE.—For purposes of this section—

"(1) IN GENERAL.—A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)—

"(A) enters into a short sale of the same or substantially identical property,

"(B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,

"(C) enters into a futures or forward contract to deliver the same or substantially identical property,

"(D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or

"(E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

"(2) EXCEPTION FOR SALES OF NONPUBLICLY TRADED PROPERTY.—The term 'constructive sale' shall not include any contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in section 453(f)) if the contract settles within 1 year after the date such contract is entered into.

"(3) EXCEPTION FOR CERTAIN CLOSED TRANSACTIONS.—In applying this section, there shall be disregarded any transaction (which would otherwise be treated as a constructive sale) during the taxable year if—

"(A) such transaction is closed before the end of the 30th day after the close of such taxable year, and

"(B) in the case of a transaction which is closed during the 90-day period ending on such 30th day—

"(i) the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date such transaction is closed, and

"(ii) at no time during such 60-day period is the taxpayer's risk of loss with respect to such position reduced by reason of a circumstance which would be described in section 246(c)(4) if references to stock included references to such position.

"(4) RELATED PERSON.—A person is related to another person with respect to a transaction if—

"(A) the relationship is described in section 267 or 707(b), and

"(B) such transaction is entered into with a view toward avoiding the purposes of this section.

"(d) OTHER DEFINITIONS.—For purposes of this section—

"(1) FORWARD CONTRACT.—The term 'forward contract' means a contract to deliver a substantially fixed amount of property for a substantially fixed price.

"(2) OFFSETTING NOTIONAL PRINCIPAL CONTRACT.—The term 'offsetting notional principal contract' means, with respect to any property, an agreement which includes—

"(A) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and

"(B) a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property.

"(e) SPECIAL RULES.—

"(1) TREATMENT OF SUBSEQUENT SALE OF POSITION WHICH WAS DEEMED SOLD.—If—

"(A) there is a constructive sale of any appreciated financial position,

"(B) such position is subsequently disposed of, and

"(C) at the time of such disposition, the transaction resulting in the constructive sale of such position is open with respect to the taxpayer or any related person,

solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, the taxpayer shall be treated as entering into such transaction immediately after such disposition. For purposes of the preceding sentence, an assignment or other termination shall be treated as a disposition.

"(2) CERTAIN TRUST INSTRUMENTS TREATED AS STOCK.—For purposes of this section, an interest in a trust which is actively traded (within the meaning of section 1092(d)(1)) shall be treated as stock.

"(3) MULTIPLE POSITIONS IN PROPERTY.—If a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold shall be made in the same manner as actual sales.

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) ELECTION OF MARK TO MARKET FOR SECURITIES TRADERS AND FOR TRADERS AND DEALERS IN COMMODITIES.—Subsection (d) of section 475 (relating to mark to market accounting method for dealers in securities) is amended by adding at the end the following new paragraph:

"(4) ELECTION OF MARK TO MARKET FOR SECURITIES TRADERS AND FOR TRADERS AND DEALERS IN COMMODITIES.—

"(A) IN GENERAL.—In the case of a person—

"(i) who is engaged in a trade or business to which this paragraph applies, and "(ii) who elects to be treated as a dealer in securities for purposes of this section with respect to such trade or business,

subsections (a), (b)(3), (c)(3), and (e) and the preceding provisions of this subsection (or, in the case of a dealer in commodities, this section) shall apply to all commodities and securities held by such person in any trade or business with respect to which such election is in effect in the same manner as if such person were a dealer in securities and all references to securities included references to commodities.

"(B) APPLICATION OF PARAGRAPH.—This paragraph shall apply to any active trade or business—

"(i) as a trader in securities, or

"(ii) as a trader or dealer in commodities.

"(C) EXCEPTION FOR CERTAIN HOLDINGS OF TRADERS.—In the case of a trader in securities or commodities, subsection (a) shall not apply to any security or commodity (to which subsection (a) would otherwise apply solely by reason of this paragraph) if such security or commodity is clearly identified in the trader's records (before the close of the day applicable under subsection (b)(2)) as being held other than in a trade or business to which the election under subparagraph (A) is in effect. A security or commodity so identified shall be treated as described in subsection (b)(1).

"(D) COMMODITY.—For purposes of this paragraph, the term 'commodities' includes only commodities of a kind customarily dealt in on an organized commodity exchange.

"(E) ELECTION.—An election under this paragraph may be made separately for each trade or business and without the consent of the Secretary. Such an election, once made, shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary."

(c) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter P of chapter 1 is amended by adding at the end the following new item:

"Sec. 1259. Constructive sales treatment for appreciated financial positions."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to any constructive sale after June 8, 1997.

(2) EXCEPTION FOR SALES OF POSITIONS, ETC. HELD BEFORE JUNE 9, 1997.—A constructive sale before June 9, 1997, and the property to which the position involved in the transaction relates, shall not be taken into account in determining whether any other constructive sale after June 8, 1997, has occurred if, within before the close of the 30-day period beginning on the date of the enactment of this Act, such position and property are clearly identified in the taxpayer's records as offsetting. The preceding sentence shall cease to apply as of the date the taxpayer ceases to hold such position or property.

(3) SPECIAL RULE.—In the case of a decedent dying after June 8, 1997, if—

(A) there was a constructive sale on or before such date of any appreciated financial position,

(B) the transaction resulting in such constructive sale of such position remains open (with respect to the decedent or any related person) for not less than 2 years after the date of such transaction (whether such period is before or after such date), and

(C) such transaction is not closed within the 30-day period beginning on the date of the enactment of this Act,

then, for purposes of such Code, such position (and any property related thereto, as determined under the principles of section 1259(d)(1) of such Code (as so added)) shall be treated as property constituting rights to receive an item of income in respect of a decedent under section 691 of such Code.

(4) ELECTION OF SECURITIES TRADERS, AND FOR TRADERS AND DEALERS IN COMMODITIES, TO BE TREATED AS DEALERS IN SECURITIES.—

(A) IN GENERAL.—The amendment made by subsection (b) shall apply to taxable years ending after the date of the enactment of this Act.

(B) 4-YEAR SPREAD OF ADJUSTMENTS.—In the case of a taxpayer who elects under section 475(d)(4) of the Internal Revenue Code of 1986 (as added by this section) to change its method of accounting for its first taxable year ending after the date of the enactment of this Act, the net amount of the adjustments required to be taken into account by the taxpayer under section 481 of the Internal Revenue Code of 1986 shall be taken into account ratably over the 4-taxable year period beginning with such first taxable year.

SEC. 1002. LIMITATION ON EXCEPTION FOR INVESTMENT COMPANIES UNDER SECTION 351.

(a) IN GENERAL.—Paragraph (1) of section 351(e) (relating to exceptions) is amended by adding at the end the following: "For purposes of the preceding sentence, the determination of whether a company is an investment company shall be made—

"(A) by taking into account all stock and securities held by the company, whether or not readily marketable, and

"(B) by treating all of the following as securities:

"(i) Money.

"(ii) Any financial instrument (as defined in section 731(c)(2)(C)).

"(iii) Any foreign currency.

"(iv) Any interest in a real estate investment trust, a common trust fund, a regulated investment company, or a publicly traded partnership (as defined in section 7704(b)).

"(v) Any interest described in clause (iv), (v), or (vi) of section 731(c)(2)(B) (or which would be so described without regard to any reference to active trading or marketability).

"(vi) Any other asset specified in regulations prescribed by the Secretary."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall apply to transfers after June 8, 1997, in taxable years ending after such date.

(2) BINDING CONTRACTS.—The amendment made by subsection (a) shall not apply to any transfer pursuant to a written binding contract in effect on June 8, 1997, that provides for the transfer of a fixed amount of property, and at all times thereafter before such transfer.

SEC. 1003. MODIFICATION OF RULES FOR ALLOCATING INTEREST EXPENSE TO TAX-EXEMPT INTEREST.

(a) PRO RATA ALLOCATION RULES APPLICABLE TO CORPORATIONS.—

(1) IN GENERAL.—Paragraph (1) of section 265(b) is amended by striking "In the case of a financial institution" and inserting "In the case of a corporation".

(2) ONLY OBLIGATIONS ACQUIRED AFTER JUNE 8, 1997, TAKEN INTO ACCOUNT.—Subparagraph (A) of section 265(b)(2) is amended by striking "August 7, 1986" and inserting "June 8, 1997 (August 7, 1986, in the case of a financial institution)".

(3) SMALL ISSUER EXCEPTION NOT TO APPLY.—Subparagraph (A) of section 265(b)(3) is amended by striking "Any qualified" and inserting "In the case of a financial institution, any qualified".

(4) EXCEPTION FOR CERTAIN BONDS ACQUIRED ON SALE OF GOODS OR SERVICES.—Subparagraph (B) of section 265(b)(4) is amended by adding at the end the following new sentence: "In the case of a taxpayer other than a financial institution, such term shall not include a nonsalable obligation acquired by such taxpayer in the ordinary course of business as payment for goods or services provided by such taxpayer to any State or local government."

(5) LOOK-THRU RULES FOR PARTNERSHIPS.—Paragraph (6) of section 265(b) is amended by adding at the end the following new subparagraph:

"(C) LOOK-THRU RULES FOR PARTNERSHIPS.—In the case of a corporation which is a partner in a partnership, such corporation shall be treated for purposes of this subsection as holding directly its allocable share of the assets of the partnership."

(6) APPLICATION OF PRO RATA DISALLOWANCE ON AFFILIATED GROUP BASIS.—Subsection (b) of section 265 is amended by adding at the end the following new paragraph:

"(7) APPLICATION OF DISALLOWANCE ON AFFILIATED GROUP BASIS.—

"(A) IN GENERAL.—For purposes of this subsection, all members of an affiliated group filing a consolidated return under section 1501 shall be treated as 1 taxpayer.

"(B) TREATMENT OF INSURANCE COMPANIES.—This subsection shall not apply to an insurance company, and subparagraph (A) shall be applied without regard to any member of an affiliated group which is an insurance company."

(6) DE MINIMIS EXCEPTION FOR NONFINANCIAL INSTITUTIONS.—Subsection (b) of section 265 is amended by adding at the end the following new paragraph:

"(8) DE MINIMIS EXCEPTION FOR NONFINANCIAL INSTITUTIONS.—In the case of a corporation, paragraph (1) shall not apply for any taxable year if the amount described in paragraph (2)(A) with respect to such corporation does not exceed the lesser of—

"(A) 2 percent of the amount described in paragraph (2)(B), or

"(B) $1,000,000.

The preceding sentence shall not apply to a financial institution or to a dealer in tax-exempt obligations."

(7) CLERICAL AMENDMENT.—The subsection heading for section 265(b) is amended by striking "FINANCIAL INSTITUTIONS" and inserting "CORPORATIONS".

(b) APPLICATION OF SECTION 265(a)(2) WITH RESPECT TO CONTROLLED GROUPS.—Paragraph (2) of section 265(a) is amended after "obligations" by inserting "held by the taxpayer (or any corporation which is a member of a controlled group (as defined in section 267(f)(1)) which includes the taxpayer)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1004. GAINS AND LOSSES FROM CERTAIN TERMINATIONS WITH RESPECT TO PROPERTY.

(a) APPLICATION OF CAPITAL TREATMENT TO PROPERTY OTHER THAN PERSONAL PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 1234A (relating to gains and losses from certain terminations) is amended by striking "personal property (as defined in section 1092(d)(1))" and inserting "property".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to terminations more than 30 days after the date of the enactment of this Act.

(b) APPLICATION OF CAPITAL TREATMENT, ETC. TO OBLIGATIONS ISSUED BY NATURAL PERSONS.—

(1) IN GENERAL.—Section 1271(b) is amended to read as follows:

"(b) EXCEPTION FOR CERTAIN OBLIGATIONS.—

"(1) IN GENERAL.—This section shall not apply to—

"(A) any obligation issued by a natural person before June 9, 1997, and

"(B) any obligation issued before July 2, 1982, by an issuer which is not a corporation and is not a government or political subdivision thereof.

"(2) TERMINATION.—Paragraph (1) shall not apply to any obligation purchased (within the meaning of section 179(d)(2)) after June 8, 1997."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall take effect on the date of enactment of this Act.

SEC. 1005. DETERMINATION OF ORIGINAL ISSUE DISCOUNT WHERE POOLED DEBT OBLIGATIONS SUBJECT TO ACCELERATION.

(a) IN GENERAL.—Subparagraph (C) of section 1272(a)(6) (relating to debt instruments to which the paragraph applies) is amended by striking "or" at the end of clause (i), by striking the period at the end of clause (ii) and inserting ", or", and by inserting after clause (i) the following:

"(iii) any pool of debt instruments the yield on which may be reduced by reason of prepayments (or to the extent provided in regulations, by reason of other events).

To the extent provided in regulations prescribed by the Secretary, in the case of a small business engaged in the trade or business of selling tangible personal property at retail, clause (iii) shall not apply to debt instruments incurred in the ordinary course of such trade or business while held by such business."

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

(2) CHANGE IN METHOD OF ACCOUNTING.—In the case of any taxpayer required by this section to change its method of accounting for its first taxable year beginning after the date of the enactment of this Act—

(A) such change shall be treated as initiated by the taxpayer,

(B) such change shall be treated as made with the consent of the Secretary, and

(C) the net amount of the adjustments required to be taken into account by the taxpayer under section 481 of the Internal Revenue Code of 1986 shall be taken into account ratably over the 4-taxable year period beginning with such first taxable year.

SEC. 1006. DENIAL OF INTEREST DEDUCTIONS ON CERTAIN DEBT INSTRUMENTS.

(a) IN GENERAL.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) DISALLOWANCE OF DEDUCTION ON CERTAIN DEBT INSTRUMENTS OF CORPORATIONS.—

"(1) IN GENERAL.—No deduction shall be allowed under this chapter for any interest paid or accrued on a disqualified debt instrument.

"(2) DISQUALIFIED DEBT INSTRUMENT.—For purposes of this subsection, the term 'disqualified debt instrument' means any indebtedness of a corporation which is payable in equity of the issuer or a related party.

"(3) SPECIAL RULES FOR AMOUNTS PAYABLE IN EQUITY.—For purposes of paragraph (2), indebtedness shall be treated as payable in equity of the issuer or a related party only if—

"(A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity,

"(B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or

"(C) the indebtedness is part of an arrangement which is reasonably expected to result in a transaction described in subparagraph (A) or (B).

For purposes of subparagraphs (A) and (B), principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

"(4) RELATED PARTY.—For purposes of this subsection, a person is a related party with respect to another person if such person bears a relationship to such other person described in section 267(b) or 707(b).

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations preventing avoidance of this subsection through the use of an issuer other than a corporation."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by this section shall apply to disqualified debt instruments issued after June 8, 1997.

(2) TRANSITION RULE.—The amendment made by this section shall not apply to any instrument issued after June 8, 1997, if such instrument is—

(A) issued pursuant to a written agreement which was binding on such date and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

Subtitle B—Corporate Organizations and Reorganizations

SEC. 1011. TAX TREATMENT OF CERTAIN EXTRAORDINARY DIVIDENDS.

(a) TREATMENT OF EXTRAORDINARY DIVIDENDS IN EXCESS OF BASIS.—Paragraph (2) of section 1059(a) (relating to corporate shareholder's recognition of gain attributable to nontaxed portion of extraordinary dividends) is amended to read as follows:

"(2) AMOUNTS IN EXCESS OF BASIS.—If the nontaxed portion of such dividends exceeds such basis, such excess shall be treated as gain from the sale or exchange of such stock for the taxable year in which the extraordinary dividend is received."

(b) TREATMENT OF REDEMPTIONS WHERE OPTIONS INVOLVED.—Paragraph (1) of section 1059(e) (relating to treatment of partial liquidations and non-pro rata redemptions) is amended to read as follows:

"(1) TREATMENT OF PARTIAL LIQUIDATIONS AND CERTAIN REDEMPTIONS.—Except as otherwise provided in regulations—

"(A) REDEMPTIONS.—In the case of any redemption of stock—

"(i) which is part of a partial liquidation (within the meaning of section 302(e)) of the redeeming corporation,

"(ii) which is not pro rata as to all shareholders, or

"(iii) which would not have been treated (in whole or in part) as a dividend if any options had not been taken into account under section 318(a)(4),

any amount treated as a dividend with respect to such redemption shall be treated as an extraordinary dividend to which paragraphs (1) and (2) of subsection (a) apply without regard to the period the taxpayer held such stock. In the case of a redemption described in clause (iii), only the basis in the stock redeemed shall be taken into account under subsection (a).

"(B) REORGANIZATIONS, ETC.—An exchange described in section 356 which is treated as a dividend shall be treated as a redemption of stock for purposes of applying subparagraph (A)."

(c) TIME FOR REDUCTION.—Paragraph (1) of section 1059(d) is amended to read as follows:

"(1) TIME FOR REDUCTION.—Any reduction in basis under subsection (a)(1) shall be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates."

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to distributions after May 3, 1995.

(2) TRANSITION RULE.—The amendments made by this section shall not apply to any distribution made pursuant to the terms of—

(A) a written binding contract in effect on May 3, 1995, and at all times thereafter before such distribution, or

(B) a tender offer outstanding on May 3, 1995.

(3) CERTAIN DIVIDENDS NOT PURSUANT TO CERTAIN REDEMPTIONS.—In determining whether the amendment made by subsection (a) applies to any extraordinary dividend other than a dividend treated as an extraordinary dividend under section 1059(e)(1) of the Internal Revenue Code of 1986 (as amended by this Act), paragraphs (1) and (2) shall be applied by substituting "September 13, 1995" for "May 3, 1995".

SEC. 1012. APPLICATION OF SECTION 355 TO DISTRIBUTIONS FOLLOWED BY ACQUISITIONS AND TO INTRAGROUP TRANSACTIONS.

(a) DISTRIBUTIONS FOLLOWED BY ACQUISITIONS.—Section 355 (relating to distribution of stock and securities of a controlled corporation) is amended by adding at the end the following new subsection:

"(e) RECOGNITION OF GAIN WHERE CERTAIN DISTRIBUTIONS OF STOCK OR SECURITIES ARE FOLLOWED BY ACQUISITION.—

"(1) GENERAL RULE.—If there is a distribution to which this subsection applies, the following rules shall apply:

"(A) ACQUISITION OF CONTROLLED CORPORATION.—If there is an acquisition described in paragraph (2)(A)(ii) with respect to any controlled corporation, any stock or securities in the controlled corporation shall not be treated as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

"(B) ACQUISITION OF DISTRIBUTING CORPORATION.—If there is an acquisition described in paragraph (2)(A)(ii) with respect to the distributing corporation, the controlled corporation shall recognize gain in an amount equal to the amount of net gain which would be recognized if all the assets of the distributing corporation (immediately after the distribution) were sold (at such time) for fair market value. Any gain recognized under the preceding sentence shall be treated as long-term capital gain and shall be taken into account for the taxable year which includes the day after the date of such distribution.

"(2) DISTRIBUTIONS TO WHICH SUBSECTION APPLIES.—

"(A) IN GENERAL.—This subsection shall apply to any distribution—

"(i) to which this section (or so much of section 356 as relates to this section) applies, and

"(ii) which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

"(B) PLAN PRESUMED TO EXIST IN CERTAIN CASES.—If 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph (A)(ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.

"(C) COORDINATION WITH SUBSECTION (d).—This subsection shall not apply to any distribution to which subsection (d) applies.

"(3) SPECIAL RULES RELATING TO ACQUISITIONS.—

"(A) CERTAIN ACQUISITIONS NOT TAKEN INTO ACCOUNT.—Except as provided in regulations, the following acquisitions shall not be treated as described in paragraph (2)(A)(ii):

"(i) The acquisition of stock in any controlled corporation by the distributing corporation.

"(ii) The acquisition by a person of stock in any controlled corporation by reason of holding stock in the distributing corporation.

"(iii) The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock in such distributing or controlled corporation.

"(iv) The acquisition of stock in a corporation if shareholders owning directly or indirectly a 50-percent or greater interest in the distributing corporation or any controlled corporation before such acquisition own indirectly a 50-percent or greater interest in such distributing or controlled corporation after such acquisition.

This subparagraph shall not apply to any acquisition if the stock held before the acquisition was acquired pursuant to a plan described in subparagraph (A)(ii).

"(B) ASSET ACQUISITIONS.—Except as provided in regulations, for purposes of this subsection, if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in a transaction described in subparagraph (A), (C), or (D) of section 368(a)(1) or any other transaction specified in regulations by the Secretary, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired.

"(4) DEFINITION AND SPECIAL RULES.—For purposes of this subsection—

"(A) 50-PERCENT OR GREATER INTEREST.—The term '50-percent or greater interest' has the meaning given such term by subsection (d)(4).

"(B) DISTRIBUTIONS IN TITLE 11 OR SIMILAR CASE.—Paragraph (1) shall not apply to any distribution made in a title 11 or similar case (as defined in section 368(a)(3)).

"(C) AGGREGATION AND ATTRIBUTION RULES.—

"(i) AGGREGATION.—The rules of paragraph (7)(A) of subsection (d) shall apply.

"(ii) ATTRIBUTION.—Section 355(d)(8)(A) shall apply in determining whether a person holds stock or securities in any corporation.

"(D) SUCCESSORS AND PREDECESSORS.—For purposes of this subsection, any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation.

"(E) STATUTE OF LIMITATIONS.—If there is an acquisition to which paragraph (1) (A) or (B) applies—

"(i) the statutory period for the assessment of any deficiency attributable to any part of the gain recognized under this subsection by reason of such acquisition shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) that such acquisition occurred, and "(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations—

"(A) providing for the application of this subsection where there is more than 1 controlled corporation,

"(B) treating 2 or more distributions as 1 distribution where necessary to prevent the avoidance of such purposes, and

"(C) providing for the application of rules similar to the rules of subsection (d)(6) where appropriate for purposes of paragraph (2)(B)."

(b) SECTION 355 NOT TO APPLY TO CERTAIN INTRAGROUP TRANSACTIONS.—Section 355, as amended by subsection (a), is amended by adding at the end the following new subsection:

"(f) SECTION NOT TO APPLY TO CERTAIN INTRAGROUP TRANSACTIONS.—Except as provided in regulations, this section shall not apply to the distribution of stock from 1 member of an affiliated group filing a consolidated return to another member of such group, and the Secretary shall provide proper adjustments for the treatment of such distribution, including (if necessary) adjustments to—

"(1) the adjusted basis of any stock which—

"(A) is in a corporation which is a member of such group, and

"(B) is held by another member of such group, and

"(2) the earnings and profits of any member of such group."

(c) DETERMINATION OF CONTROL IN CERTAIN DIVISIVE TRANSACTIONS.—

(1) SECTION 351 TRANSACTIONS.—Section 351(c) (relating to special rule) is amended to read as follows:

"(c) SPECIAL RULES WHERE DISTRIBUTION TO SHAREHOLDERS.—

"(1) IN GENERAL.—In determining control for purposes of this section—

"(A) the fact that any corporate transferor distributes part or all of the stock in the corporation which it receives in the exchange to its shareholders shall not be taken into account, and

"(B) if the requirements of section 355 are met with respect to such distribution, the shareholders shall be treated as in control of such corporation immediately after the exchange if the shareholders hold at least a 50-percent interest in such corporation immediately after the distribution.

"(2) 50-PERCENT INTEREST.—For purposes of this subsection, the term '50-percent interest' means stock possessing 50 percent of the total combined voting power of all classes of stock entitled to vote and 50 percent of the total value of shares of all classes of stock."

(2) D REORGANIZATIONS.—Section 368(a)(2)(H) (relating to special rule for determining whether certain transactions are

qualified under paragraph (1)(D)) is amended to read as follows:

"(H) SPECIAL RULES FOR DETERMINING WHETHER CERTAIN TRANSACTIONS ARE QUALIFIED UNDER PARAGRAPH (1)(D).—For purposes of determining whether a transaction qualifies under paragraph (1)(D)—

"(i) in the case of a transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, the term 'control' has the meaning given such term by section 304(c), and

"(ii) in the case of a transaction with respect to which the requirements of section 355 are met, the shareholders described in paragraph (1)(D) shall be treated as having control of the corporation to which the assets are transferred if such shareholders hold a 50-percent or greater interest (as defined in section 351(c)(2)) in such corporation immediately after the transfer."

(d) EFFECTIVE DATES.—

(1) SECTION 355 RULES.—The amendments made by subsections (a) and (b) shall apply to distributions after April 16, 1997.

(2) DIVISIVE TRANSACTIONS.—The amendments made by subsection (c) shall apply to transfers after the date of the enactment of this Act.

(3) TRANSITION RULE.—The amendments made by this section shall not apply to any distribution after April 16, 1997, if such distribution is—

(A) made pursuant to a written agreement which was binding on such date and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

This paragraph shall not apply to any written agreement, ruling request, or public announcement or filing unless it identifies the unrelated acquirer of the distributing corporation or of any controlled corporation, whichever is applicable.

SEC. 1013. TAX TREATMENT OF REDEMPTIONS INVOLVING RELATED CORPORATIONS.

(a) STOCK PURCHASES BY RELATED CORPORATIONS.—The last sentence of section 304(a)(1) (relating to acquisition by related corporation other than subsidiary) is amended to read as follows: "To the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction."

(b) COORDINATION WITH SECTION 1059.—Clause (iii) of section 1059(e)(1)(A), as amended by this title, is amended to read as follows:

"(iii) which would not have been treated (in whole or in part) as a dividend if—

"(I) any options had not been taken into account under section 318(a)(4), or

"(II) section 304(a) had not applied,".

(c) SPECIAL RULE FOR ACQUISITIONS BY FOREIGN CORPORATIONS.—Section 304(b) (relating to special rules for application of subsection (a)) is amended by adding at the end the following new paragraph:

"(5) ACQUISITIONS BY FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—In the case of any acquisition to which subsection (a) applies in which the acquiring corporation is a foreign corporation, the only earnings and profits taken into account under paragraph (2)(A) shall be those earnings and profits—

"(i) which are attributable (under regulations prescribed by the Secretary) to stock of the acquiring corporation owned (within the meaning of section 958(a)) by a corporation or individual which is—

"(I) a United States shareholder (within the meaning of section 951(b)) of the acquiring corporation, and

"(II) the transferor or a person who bears a relationship to the transferor described in section 267(b) or 707(b), and

"(ii) which were accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation.

"(B) APPLICATION OF SECTION 1248.—For purposes of subparagraph (A), the rules of section 1248(d) shall apply except to the extent otherwise provided by the Secretary.

"(C) REGULATIONS.—The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of this paragraph."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to distributions and acquisitions after June 8, 1997.

(2) TRANSITION RULE.—The amendments made by this section shall not apply to any distribution or acquisition after June 8, 1997, if such distribution or acquisition is—

(A) made pursuant to a written agreement which was binding on such date and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

SEC. 1014. MODIFICATION OF HOLDING PERIOD APPLICABLE TO DIVIDENDS RECEIVED DEDUCTION.

(a) IN GENERAL.—Subparagraph (A) of section 246(c)(1) is amended to read as follows:

"(A) which is held by the taxpayer for 45 days or less during the 90-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend, or".

(b) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 246(c) is amended to read as follows:

"(2) 90-DAY RULE IN THE CASE OF CERTAIN PREFERENCE DIVIDENDS.—In the case of stock having preference in dividends, if the taxpayer receives dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A) shall be applied—

"(A) by substituting '90 days' for '45 days' each place it appears, and

"(B) by substituting '180-day period' for '90-day period'."

(2) Paragraph (3) of section 246(c) is amended by adding "and" at the end of subparagraph (A), by striking subparagraph (B), and by redesignating subparagraph (C) as subparagraph (B).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to dividends received or accrued after the 30th day after the date of the enactment of this Act.

Subtitle C—Other Corporate Provisions

SEC. 1021. REGISTRATION AND OTHER PROVISIONS RELATING TO CONFIDENTIAL CORPORATE TAX SHELTERS.

(a) IN GENERAL.—Section 6111 (relating to registration of tax shelters) is amended by redesignating subsections (d) and (e) as subsections (e) and (f), respectively, and by inserting after subsection (c) the following new subsection:

"(d) CERTAIN CONFIDENTIAL ARRANGEMENTS TREATED AS TAX SHELTERS.—

"(1) IN GENERAL.—For purposes of this section, the term 'tax shelter' includes any entity, plan, arrangement, or transaction—

"(A) a significant purpose of the structure of which is the avoidance or evasion of Federal income tax for a direct or indirect participant which is a corporation,

"(B) which is offered to any potential participant under conditions of confidentiality, and

"(C) for which the tax shelter promoters may receive fees in excess of $100,000 in the aggregate.

"(2) CONDITIONS OF CONFIDENTIALITY.—For purposes of paragraph (1)(B), an offer is under conditions of confidentiality if—

"(A) the potential participant to whom the offer is made (or any other person acting on behalf of such participant) has an understanding or agreement with or for the benefit of any promoter of the tax shelter that such participant (or such other person) will limit disclosure of the tax shelter or any significant tax features of the tax shelter, or

"(B) any promoter of the tax shelter—

"(i) claims, knows, or has reason to know,

"(ii) knows or has reason to know that any other person (other than the potential participant) claims, or

"(iii) causes another person to claim,

that the tax shelter (or any aspect thereof) is proprietary to any person other than the potential participant or is otherwise protected from disclosure to or use by others.

For purposes of this subsection, the term 'promoter' means any person or any related person (within the meaning of section 267 or 707) who participates in the organization, management, or sale of the tax shelter.

"(3) PERSONS OTHER THAN PROMOTER REQUIRED TO REGISTER IN CERTAIN CASES.—

"(A) IN GENERAL.—If—

"(i) the requirements of subsection (a) are not met with respect to any tax shelter (as defined in paragraph (1)) by any tax shelter promoter, and

"(ii) no tax shelter promoter is a United States person,

then each United States person who discussed participation in such shelter shall register such shelter under subsection (a).

"(B) EXCEPTION.—Subparagraph (A) shall not apply to a United States person who discussed participation in a tax shelter if—

"(i) such person notified the promoter in writing (not later than the close of the 90th day after the day on which such discussions began) that such person would not participate in such shelter, and

"(ii) such person does not participate in such shelter.

"(4) OFFER TO PARTICIPATE TREATED AS OFFER FOR SALE.—For purposes of subsections (a) and (b), an offer to participate in a tax shelter (as defined in paragraph (1)) shall be treated as an offer for sale."

(b) PENALTY.—Subsection (a) of section 6707 (relating to failure to furnish information regarding tax shelters) is amended by adding at the end the following new paragraph:

"(3) CONFIDENTIAL ARRANGEMENTS.—

"(A) IN GENERAL.—In the case of a tax shelter (as defined in section 6111(d)), the penalty imposed under paragraph (1) shall be an amount equal to the greater of—

"(i) 50 percent of the fees paid to all promoters of the tax shelter with respect to offerings made before the date such shelter is registered under section 6111, or

"(ii) $10,000.

Clause (i) shall be applied by substituting '75 percent' for '50 percent' in the case of an intentional failure or act described in paragraph (1).

"(B) SPECIAL RULE FOR PARTICIPANTS REQUIRED TO REGISTER SHELTER.—In the case of a person required to register such a tax shelter by reason of section 6111(d)(3)—

"(i) such person shall be required to pay the penalty under paragraph (1) only if such person actually participated in such shelter,

"(ii) the amount of such penalty shall be determined by taking into account under subparagraph (A)(i) only the fees paid by such person, and

"(iii) such penalty shall be in addition to the penalty imposed on any other person for failing to register such shelter."

(c) MODIFICATIONS TO SUBSTANTIAL UNDERSTATEMENT PENALTY.—

(1) RESTRICTION ON REASONABLE BASIS FOR CORPORATE UNDERSTATEMENT OF INCOME TAX.—Subparagraph (B) of section 6662(d)(2) is amended by adding at the end the following new flush sentence:

"For purposes of clause (ii)(II), in no event shall a corporation be treated as having a reasonable basis for its tax treatment of an item attributable to a multiple-party financing transaction if such treatment does not clearly reflect the income of the corporation."

(2) MODIFICATION TO DEFINITION OF TAX SHELTER.—Clause (iii) of section 6662(d)(2)(C) is amended by striking "the principal purpose" and inserting "a significant purpose".

(d) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 6707(a) is amended by striking "The penalty" and inserting "Except as provided in paragraph (3), the penalty".

(2) Subparagraph (A) of section 6707(a)(1) is amended by striking "paragraph (2)" and inserting "paragraph (2) or (3), as the case may be".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to any tax shelter (as defined in section 6111(d) of the Internal Revenue Code of 1986, as amended by this section) interests in which are offered to potential participants after the Secretary of the Treasury prescribes guidance with respect to meeting requirements added by such amendments.

(2) MODIFICATIONS TO SUBSTANTIAL UNDERSTATEMENT PENALTY.—The amendments made by subsection (c) shall apply to items with respect to transactions entered into after the date of the enactment of this Act.

SEC. 1022. CERTAIN PREFERRED STOCK TREATED AS BOOT.

(a) SECTION 351.—Section 351 (relating to transfer to corporation controlled by transferor) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) NONQUALIFIED PREFERRED STOCK NOT TREATED AS STOCK.—

"(1) IN GENERAL.—For purposes of subsections (a) and (b), the term 'stock' shall not include nonqualified preferred stock.

"(2) NONQUALIFIED PREFERRED STOCK.—For purposes of paragraph (1)—

"(A) IN GENERAL.—The term 'nonqualified preferred stock' means preferred stock if—

"(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,

"(ii) the issuer or a related person is required to redeem or purchase such stock,

"(iii) 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

"(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

"(B) LIMITATIONS.—Clauses (i), (ii), and (iii) of subparagraph (A) shall apply only if the right or obligation referred to therein may be exercised within the 20-year period beginning on the issue date of such stock 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.

"(C) EXCEPTIONS FOR CERTAIN RIGHTS OR OBLIGATIONS.—

"(i) IN GENERAL.—A right or obligation shall not be treated as described in clause (i), (ii), or (iii) of subparagraph (A) if—

"(I) it may be exercised only upon the death, disability, or mental incompetency of the holder, or

"(II) in the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or a related person.

"(ii) EXCEPTION.—Clause (i)(I) shall not apply if the stock relinquished in the exchange, or the stock acquired in the exchange is in—

"(I) a corporation if any class of stock in such corporation or a related party is readily tradable on an established securities market or otherwise, or

"(II) any other corporation if such exchange is part of a transaction or series of transactions in which such corporation is to become a corporation described in subclause (I).

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) PREFERRED STOCK.—The term 'preferred stock' means stock which is limited and preferred as to dividends and does not participate (including through a conversion privilege) in corporate growth to any significant extent.

"(B) RELATED PERSON.—A person shall be treated as related to another person if they bear a relationship to such other person described in section 267(b) or 707(b).

"(4) REGULATIONS.—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Secretary may also prescribe regulations, consistent with the treatment under this subsection and such sections, for the treatment of nonqualified preferred stock under other provisions of this title."

(b) SECTION 354.—Paragraph (2) of section 354(a) (relating to exchanges of stock and securities in certain reorganizations) is amended by adding at the end the following new subparagraph:

"(C) NONQUALIFIED PREFERRED STOCK.—

"(i) IN GENERAL.—Nonqualified preferred stock (as defined in section 351(g)(2)) received in exchange for stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities.

"(ii) RECAPITALIZATIONS OF FAMILY-OWNED CORPORATIONS.—

"(I) IN GENERAL.—Clause (i) shall not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation.

"(II) FAMILY-OWNED CORPORATION.—For purposes of this clause, except as provided in regulations, the term 'family-owned corporation' means any corporation which is described in clause (i) of section 447(d)(2)(C) throughout the 8-year period beginning on the date which is 5 years before the date of the recapitalization. For purposes of the preceding sentence, stock shall not be treated as owned by a family member during any period described in section 355(d)(6)(B)."

(c) SECTION 355.—Paragraph (3) of section 355(a) is amended by adding at the end the following new subparagraph:

"(D) NONQUALIFIED PREFERRED STOCK.—Nonqualified preferred stock (as defined in section 351(g)(2)) received in a distribution with respect to stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities."

(d) SECTION 356.—Section 356 is amended by redesignating subsections (e) and (f) as subsections (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) NONQUALIFIED PREFERRED STOCK TREATED AS OTHER PROPERTY.—For purposes of this section—

"(1) IN GENERAL.—Except as provided in paragraph (2), the term 'other property' includes nonqualified preferred stock (as defined in section 351(g)(2)).

"(2) EXCEPTION.—The term 'other property' does not include nonqualified preferred stock (as so defined) to the extent that, under section 354 or 355, such preferred stock would be permitted to be received without the recognition of gain."

(e) CONFORMING AMENDMENTS.—

(1) Subparagraph (B) of section 354(a)(2) and subparagraph (C) of section 355(a)(3)(C) are each amended by inserting "(including nonqualified preferred stock, as defined in section 351(g)(2))" after "stock".

(2) Subparagraph (A) of section 354(a)(3) and subparagraph (A) of section 355(a)(4) are each amended by inserting "nonqualified preferred stock and" after "including".

(3) Section 1036 is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) NONQUALIFIED PREFERRED STOCK NOT TREATED AS STOCK.—For purposes of this section, nonqualified preferred stock (as defined in section 351(g)(2)) shall be treated as property other than stock."

(f) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to transactions after June 8, 1997.

(2) TRANSITION RULE.—The amendments made by this section shall not apply to any transaction after June 8, 1997, if such transaction is—

(A) made pursuant to a written agreement which was binding on such date and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

Subtitle D—Administrative Provisions

SEC. 1031. REPORTING OF CERTAIN PAYMENTS MADE TO ATTORNEYS.

(a) IN GENERAL.—Section 6045 (relating to returns of brokers) is amended by adding at the end the following new subsection:

"(f) RETURN REQUIRED IN THE CASE OF PAYMENTS TO ATTORNEYS.—

"(1) IN GENERAL.—Any person engaged in a trade or business and making a payment (in the course of such trade or business) to which this subsection applies shall file a return under subsection (a) and a statement under subsection (b) with respect to such payment.

"(2) APPLICATION OF SUBSECTION.—

"(A) IN GENERAL.—This subsection shall apply to any payment to an attorney in connection with legal services (whether or not such services are performed for the payor).

"(B) EXCEPTION.—This subsection shall not apply to the portion of any payment which is required to be reported under section 6041(a) (or would be so required but for the dollar limitation contained therein) or section 6051."

(b) REPORTING OF ATTORNEYS' FEES PAYABLE TO CORPORATIONS.—The regulations providing an exception under section 6041 of the Internal Revenue Code of 1986 for payments made to corporations shall not apply to payments of attorneys' fees.

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to payments made after December 31, 1997.

SEC. 1032. DECREASE OF THRESHOLD FOR REPORTING PAYMENTS TO CORPORATIONS PERFORMING SERVICES FOR FEDERAL AGENCIES.

(a) IN GENERAL.—Subsection (d) of section 6041A (relating to returns regarding payments of remuneration for services and direct sales) is amended by adding at the end the following new paragraph:

"(3) PAYMENTS TO CORPORATIONS BY FEDERAL EXECUTIVE AGENCIES.—

"(A) IN GENERAL.—Notwithstanding any regulation prescribed by the Secretary before the date of the enactment of this paragraph, subsection (a) shall apply to remuneration paid to a corporation by any Federal executive agency (as defined in section 6050M(b)).

"(B) EXCEPTION.—Subparagraph (A) shall not apply to—

"(i) services under contracts described in section 6050M(e)(3) with respect to which the requirements of section 6050M(e)(2) are met, and

"(ii) such other services as the Secretary may specify in regulations prescribed after the date of the enactment of this paragraph."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to returns the due date for which (determined without regard to any extension) is more than 90 days after the date of the enactment of this Act.

SEC. 1033. DISCLOSURE OF RETURN INFORMATION FOR ADMINISTRATION OF CERTAIN VETERANS PROGRAMS.

(a) GENERAL RULE.—Subparagraph (D) of section 6103(l)(7) (relating to disclosure of return information to Federal, State, and local agencies administering certain programs) is amended by striking "Clause (viii) shall not apply after September 30, 1998."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 1034. CONTINUOUS LEVY ON CERTAIN PAYMENTS.

(a) IN GENERAL.—Section 6331 (relating to levy and distraint) is amended—

(1) by redesignating subsection (h) as subsection (i), and

(2) by inserting after subsection (g) the following new subsection:

"(h) CONTINUING LEVY ON CERTAIN PAYMENTS.—

"(1) IN GENERAL.—The effect of a levy on specified payments to or received by a taxpayer shall be continuous from the date such levy is first made until such levy is released. Notwithstanding section 6334, such continuous levy shall attach to up to 15 percent of any specified payment due to the taxpayer.

"(2) SPECIFIED PAYMENT.—For the purposes of paragraph (1), the term 'specified payment' means—

"(A) any Federal payment other than a payment for which eligibility is based on the income or assets (or both) of a payee, "(B) any payment described in paragraph (4), (7), (9), or (11) of section 6334(a), and

"(C) any annuity or pension payment under the Railroad Retirement Act or benefit under the Railroad Unemployment Insurance Act described in subsection (a)(6) of this section."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to levies issued after the date of the enactment of this Act.

SEC. 1035. MODIFICATION OF LEVY EXEMPTION.

(a) IN GENERAL.—Section 6334 (relating to property exempt from levy) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) LEVY ALLOWED ON CERTAIN SPECIFIED PAYMENTS.—Any payment described in subparagraph (B) or (C) of section 6331(h)(2) shall not be exempt from levy if the Secretary approves the levy thereon under section 6331(h)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to levies issued after the date of the enactment of this Act.

SEC. 1036. CONFIDENTIALITY AND DISCLOSURE OF RETURNS AND RETURN INFORMATION.

(a) IN GENERAL.—Subsection (k) of section 6103 is amended by adding at the end the following new paragraph:

"(8) LEVIES ON CERTAIN GOVERNMENT PAYMENTS.—

"(A) DISCLOSURE OF RETURN INFORMATION IN LEVIES ON FINANCIAL MANAGEMENT SERVICE.—In serving a notice of levy, or release of such levy, with respect to any applicable government payment, the Secretary may disclose to officers and employees of the Financial Management Service—

"(i) return information, including taxpayer identity information,

"(ii) the amount of any unpaid liability under this title (including penalties and interest), and

"(iii) the type of tax and tax period to which such unpaid liability relates.

"(B) RESTRICTION ON USE OF DISCLOSED INFORMATION.—Return information disclosed under subparagraph (A) may be used by officers and employees of the Financial Management Service only for the purpose of, and to the extent necessary in, transferring levied funds in satisfaction of the levy, maintaining appropriate agency records in regard to such levy or the release thereof, notifying the taxpayer and the agency certifying such payment that the levy has been honored, or in the defense of any litigation ensuing from the honor of such levy.

"(C) APPLICABLE GOVERNMENT PAYMENT.—For purposes of this paragraph, the term 'applicable government payment' means—

"(i) any Federal payment (other than a payment for which eligibility is based on the income or assets (or both) of a payee) certified to the Financial Management Service for disbursement, and

"(ii) any other payment which is certified to the Financial Management Service for disbursement and which the Secretary designates by published notice.".

(b) CONFORMING AMENDMENTS.—

(1) Section 6301(p) is amended—

(A) in paragraph (3)(A), by striking "(2), or (6)" and inserting "(2), (6), or (8), and

(B) in paragraph (4), by inserting "(k)(8)," after "(j) (1) or (2)," each place it appears.

(2) Section 552a(a)(8)(B) of title 5, United States Code, is amended by striking "or" at the end of clause (v), by adding "or" at the end of clause (vi), and by adding at the end the following new clause:

"(vii) matches performed incident to a levy described in section 6103(k)(8) of the Internal Revenue Code of 1986;".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to levies issued after the date of the enactment of this Act.

SEC. 1037. RETURNS OF BENEFICIARIES OF ESTATES AND TRUSTS REQUIRED TO FILE RETURNS CONSISTENT WITH ESTATE OR TRUST RETURN OR TO NOTIFY SECRETARY OF INCONSISTENCY.

(a) DOMESTIC ESTATES AND TRUSTS.—Section 6034A (relating to information to beneficiaries of estates and trusts) is amended by adding at the end the following new subsection:

"(c) BENEFICIARY'S RETURN MUST BE CONSISTENT WITH ESTATE OR TRUST RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.—

"(1) IN GENERAL.—A beneficiary of any estate or trust to which subsection (a) applies shall, on such beneficiary's return, treat any reported item in a manner which is consistent with the treatment of such item on the applicable entity's return.

"(2) NOTIFICATION OF INCONSISTENT TREATMENT.—

"(A) IN GENERAL.—In the case of any reported item, if—

"(i)(I) the applicable entity has filed a return but the beneficiary's treatment on such beneficiary's return is (or may be) inconsistent with the treatment of the item on the applicable entity's return, or

"(II) the applicable entity has not filed a return, and

"(ii) the beneficiary files with the Secretary a statement identifying the inconsistency,

paragraph (1) shall not apply to such item.

"(B) BENEFICIARY RECEIVING INCORRECT INFORMATION.—A beneficiary shall be treated as having complied with clause (ii) of subparagraph (A) with respect to a reported item if the beneficiary—

"(i) demonstrates to the satisfaction of the Secretary that the treatment of the reported item on the beneficiary's return is consistent with the treatment of the item on the statement furnished under subsection (a) to the beneficiary by the applicable entity, and "(ii) elects to have this paragraph apply with respect to that item.

"(3) EFFECT OF FAILURE TO NOTIFY.—In any case—

"(A) described in subparagraph (A)(i)(I) of paragraph (2), and

"(B) in which the beneficiary does not comply with subparagraph (A)(ii) of paragraph (2),

any adjustment required to make the treatment of the items by such beneficiary consistent with the treatment of the items on the applicable entity's return shall be treated as arising out of mathematical or clerical errors and assessed according to section 6213(b)(1). Paragraph (2) of section 6213(b) shall not apply to any assessment referred to in the preceding sentence.

"(4) DEFINITIONS.—For purposes of this subsection—

"(A) REPORTED ITEM.—The term 'reported item' means any item for which information is required to be furnished under subsection (a).

"(B) APPLICABLE ENTITY.—The term 'applicable entity' means the estate or trust of which the taxpayer is the beneficiary.

"(5) ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION.—For addition to tax in the case of a beneficiary's negligence in connection with, or disregard of, the requirements of this section, see part II of subchapter A of chapter 68."

(b) FOREIGN TRUSTS.—Subsection (d) of section 6048 (relating to information with respect to certain foreign trusts) is amended by adding at the end the following new paragraph:

"(5) UNITED STATES PERSON'S RETURN MUST BE CONSISTENT WITH TRUST RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.—Rules similar to the rules of section 6034A(c) shall apply to items reported by a trust under subsection (b)(1)(B) and to United States persons referred to in such subsection."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to returns of beneficiaries and owners filed after the date of the enactment of this Act.

Subtitle E—Excise Tax Provisions

SEC. 1041. EXTENSION AND MODIFICATION OF AIRPORT AND AIRWAY TRUST FUND TAXES.

(a) FUEL TAXES.—

(1) AVIATION FUEL.—Clause (ii) of section 4091(b)(3)(A) is amended by striking "September 30, 1997" and inserting "September 30, 2007".

(2) AVIATION GASOLINE.—Subparagraph (B) of section 4081(d)(2) is amended by striking "September 30, 1997" and inserting "September 30, 2007".

(3) NONCOMMERCIAL AVIATION.—Subparagraph (B) of section 4041(c)(3) is amended by striking "September 30, 1997" and inserting "September 30, 2007".

(b) TICKET TAXES.—

(1) PERSONS.—Clause (ii) of section 4261(g)(1)(A) is amended by striking "September 30, 1997" and inserting "September 30, 2007".

(2) PROPERTY.—Clause (ii) of section 4271(d)(1)(A) is amended by striking "September 30, 1997" and inserting "September 30, 2007".

(c) MODIFICATIONS TO TAX ON TRANSPORTATION OF PERSONS BY AIR.—

(1) IN GENERAL.—Section 4261 (relating to imposition of tax) is amended by striking subsections (a), (b), and (c) and inserting the following new subsections:

"(a) IN GENERAL.—There is hereby imposed on the amount paid for taxable transportation of any person a tax equal to 7.5 percent of the amount so paid.

"(b) DOMESTIC SEGMENTS OF TAXABLE TRANSPORTATION.—

"(1) IN GENERAL.—There is hereby imposed on the amount paid for each domestic segment of taxable transportation by air a tax in the amount determined in accordance with the following table for the calendar year in which the segment begins:

In the case of segments beginning during:	**The tax is:**
1997 or 1998	$2.00
1999	$2.25
2000	$2.50
2001	$2.75
2002 or thereafter	$3.00

"(2) DOMESTIC SEGMENT.—For purposes of this section, the term 'domestic segment' means any segment which is taxable transportation described in section 4262(a)(1).

"(3) CHANGES IN SEGMENTS BY REASON OF REROUTING.—If—

"(A) a ticket is purchased for transportation between 2 locations on specified flights, and

"(B) at the initiation of the air carrier after such purchase, there is a change in the route taken which changes the number of domestic segments, but there is no change in the amount charged for such transportation,

the tax imposed by paragraph (1) shall be determined without regard to such change in route.

"(c) USE OF INTERNATIONAL TRAVEL FACILITIES.—

"(1) IN GENERAL.—There is hereby imposed a tax of $15.50 on any amount paid (whether within or without the United States) for any transportation of any person by air, if such transportation begins or ends in the United States.

"(2) EXCEPTION FOR TRANSPORTATION ENTIRELY TAXABLE UNDER SUBSECTION (a).—This subsection shall not apply to any transportation all of which is taxable under subsection (a) (determined without regard to sections 4281 and 4282).

"(3) SPECIAL RULE FOR ALASKA AND HAWAII.—In any case in which the tax imposed by paragraph (1) applies to a domestic segment, such tax shall apply only on departure."

(2) SPECIAL RULES.—Section 4261 is amended by redesignating subsections (e), (f), and (g), as subsections (f), (g), and (h), respectively, and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULES.—

"(1) AMOUNTS PAID OUTSIDE THE UNITED STATES.—In the case of amounts paid outside the United States for taxable transportation, the taxes imposed by subsections (a) and (b) shall apply only to segments of such transportation which begin and end in the United States.

"(2) AMOUNTS PAID FOR RIGHT TO AWARD FREE OR REDUCED RATE AIR TRANSPORTATION.—Any amount paid (and the value of any other benefit provided) to an air carrier (or any related person) for the right to provide mileage awards for (or other reductions in the cost of) any transportation of persons by air shall be treated for purposes of subsection (a) as an amount paid for taxable transportation, and such amount shall be taxable under subsection (a) without regard to any other provision of this subchapter. The Secretary shall prescribe rules which reallocate items of income, deduction, credit, exclusion, or other allowance to the extent necessary to prevent the avoidance of tax imposed by reason of this paragraph.

"(3) INFLATION ADJUSTMENT OF DOLLAR RATES OF TAX.—

"(A) IN GENERAL.—In the case of taxable events in a calendar year after the last nonindexed year, the dollar amount contained in subsection (b) and the dollar amount contained in subsection (c) shall each be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting the year before the last nonindexed year for 'calendar year 1992' in subparagraph (B) thereof.

If any increase determined under the preceding sentence is not a multiple of 10 cents, such increase shall be rounded to the nearest multiple of 10 cents.

"(B) LAST NONINDEXED YEAR.—For purposes of subparagraph (A), the last nonindexed year is—

"(i) 2002 in the case of a dollar amount contained in subsection (b), and

"(ii) 1998 in the case of a dollar amount contained in subsection (c).

"(C) TAXABLE EVENT.—For purposes of subparagraph (A), in the case of the tax imposed subsection (b), the beginning of the domestic segment shall be treated as the taxable event."

(3) SECONDARY LIABILITY OF CARRIER FOR UNPAID TAX.—Subsection (c) of section 4263 is amended by striking "subchapter—" and all that follows and inserting ", such tax shall be paid by the carrier providing the initial segment of such transportation which begins or ends in the United States."

(d) MODIFICATION OF RULES ON AIRLINE FARE ADVERTISING.—Subsection (b) of section 7275 (relating to advertising) is amended by striking "shall—" and all that follows and inserting "shall—

"(1) separately state—

"(A) the amount to be paid for such transportation, and

"(B) the amount of the taxes imposed by subsections (a), (b), and (c) of section 4261 at a location proximate to (and in a type size not less than half the type size of) the statement of the amount described in subparagraph (A), and

"(2) describe such taxes substantially as: 'user taxes to pay for airport construction and airway safety and operations'."

(e) INCREASED AIRPORT AND AIRWAY TRUST FUND DEPOSITS.—

(1) Paragraph (1) of section 9502(b) is amended—

(A) by striking "(to the extent that the rate of the tax on such gasoline exceeds 4.3 cents per gallon)" in subparagraph (C), and

(B) by striking "to the extent attributable to the Airport and Airway Trust Fund financing rate" in subparagraph (C).

(2) Section 9502 is amended by striking subsection (f).

(f) EFFECTIVE DATES.—

(1) FUEL TAXES.—The amendments made by subsection (a) shall apply take effect on October 1, 1997.

(2) TICKET TAXES.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, the amendments made by subsections (b) and (c) shall apply to transportation beginning on or after October 1, 1997.

(B) TREATMENT OF AMOUNTS PAID FOR TICKETS PURCHASED BEFORE DATE OF ENACTMENT.—The amendments made by subsection (c) shall not apply to amounts paid for a ticket purchased before the date of the enactment of this Act for a specified flight beginning on or after October 1, 1997.

(C) AMOUNTS PAID FOR RIGHT TO AWARD MILEAGE AWARDS.—

(i) IN GENERAL.—Paragraph (2) of section 4261(e) of the Internal Revenue Code of 1986 (as added by the amendment made by subsection (c)) shall apply to amounts paid after September 30, 1997.

(ii) PAYMENTS WITHIN CONTROLLED GROUP.—For purposes of clause (i), any amount paid after June 11, 1997, and before October 1, 1997, by 1 member of a controlled group for a right which is described in such section 4261(e)(2) and is furnished by another member of such group after September 30, 1997, shall be treated as paid after September 30, 1997. For purposes of the preceding sentence, all persons treated as a single employer under subsection (a) or (b) of section 52 of such Code shall be treated as members of a controlled group.

(3) ADVERTISING.—The amendment made by subsection (d) shall take effect on October 1, 1997.

(4) INCREASED DEPOSITS INTO AIRPORT AND AIRWAY TRUST FUND.—The amendments made by subsection (e) shall apply with respect to taxes received in the Treasury on and after October 1, 1997.

(g) DELAYED DEPOSITS OF AIRLINE TICKET TAX REVENUES.—In the case of deposits of taxes imposed by section 4261 of the Internal Revenue Code of 1986, the due date for any such deposit which would (but for this subsection) be required to be made after August 14, 1997, and before October 1, 1997, shall be October 10, 1997.

SEC. 1042. KEROSENE TAXED AS DIESEL FUEL.

(a) IN GENERAL.—Subsection (a) of section 4083 (defining taxable fuel) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following new subparagraph:

"(C) kerosene."

(b) RATE OF TAX.—Clause (iii) of section 4081(a)(2)(A) is amended by inserting "or kerosene" after "diesel fuel".

(c) EXEMPTIONS FROM TAX; REFUNDS TO VENDORS.—

(1) IN GENERAL.—Section 4082 (relating to exemptions for diesel fuel) is amended by striking "diesel fuel" each place it appears in subsections (a) and (c) and inserting "diesel fuel and kerosene".

(2) CERTAIN KEROSENE EXEMPT FROM DYEING REQUIREMENT.—Section 4082 is amended by redesignating subsections (c) and (d) as subsections (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) EXCEPTIONS TO DYEING REQUIREMENTS.—

"(1) AVIATION-GRADE KEROSENE.—Subsection (a)(2) shall not apply to a removal, entry, or sale of aviation-grade kerosene (as determined under regulations prescribed by the Secretary) if the person receiving the kerosene is registered under section 4101 with respect to the tax imposed by section 4091.

"(2) USE FOR NON-FUEL FEEDSTOCK PURPOSES.—Subsection (a)(2) shall not apply to kerosene—

"(A) received by pipeline or barge for use by the person receiving the kerosene in the manufacture or production of any substance (other than gasoline, diesel fuel, or special fuels referred to in section 4041), or

"(B) to the extent provided in regulations, removed or entered—

"(i) for such a use by the person removing or entering the kerosene, or

"(ii) for resale by such person for such a use by the purchaser,

but only if the person receiving, removing, or entering the kerosene and such purchaser (if any) are registered under section 4101 with respect to the tax imposed by section 4081."

(3) REFUNDS.—

(A) Subsection (l) of section 6427 is amended by inserting "or kerosene" after "diesel fuel" each place it appears in paragraphs (1), (2), and (5) (including the heading for paragraph (5)).

(B) Paragraph (5) of section 6427(l) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) SALES OF KEROSENE NOT FOR USE IN MOTOR FUEL.—Paragraph (1)(A) shall not apply to kerosene sold by a vendor—

"(i) for any use if such sale is from a pump which (as determined under regulations prescribed by the Secretary) is not suitable for use in fueling any diesel-powered highway vehicle or train, or

"(ii) to the extent provided by the Secretary, for blending with heating oil to be used during periods of extreme or unseasonable cold."

(C) Subparagraph (C) of section 6427(l)(5), as redesignated by subparagraph (B) of this paragraph, is amended by striking "subparagraph (A)" and inserting "subparagraph (A) or (B)".

(D) The heading for subsection (l) of section 6427 is amended by inserting ", KEROSENE," after "DIESEL FUEL".

(d) CONFORMING AMENDMENTS.—

(1) Paragraph (2) of section 4041(a) is amended by striking "kerosene, gas oil, or fuel oil" and inserting "gas oil, fuel oil".

(2) Paragraph (1) of section 4041(c) is amended by striking "any liquid" and inserting "kerosene and any other liquid".

(3)(A) The heading for section 4082 is amended by inserting "**AND KEROSENE**" after "**DIESEL FUEL**".

(B) The table of sections for subpart A of part III of subchapter A of chapter 32 is amended by inserting "and kerosene" after "diesel fuel" in the item relating to section 4082.

(4) Subsection (b) of section 4083 is amended by striking "gasoline, diesel fuel," and inserting "taxable fuels".

(5) Subsection (a) of section 4093 is amended by striking "any liquid" and inserting "kerosene and any other liquid".

(6) The material following subparagraph (F) of section 6416(b)(2) is amended by inserting "or kerosene" after "diesel fuel".

(7) Paragraphs (1) and (3) of section 6427(f), and the heading for section 6427(f), are each amended by inserting "kerosene," after "diesel fuel,".

(8) Paragraph (2) of section 6427(f) is amended by striking "or diesel fuel" each place it appears and inserting ", diesel fuel, or kerosene".

(9) Subparagraph (A) of section 6427(i)(3) is amended by striking "or diesel fuel" and inserting ", diesel fuel, or kerosene".

(10) The heading for paragraph (4) of section 6427(i) is amended to read as follows:

"(4) SPECIAL RULE FOR REFUNDS UNDER SUBSECTION (l).—"

(11) Paragraph (1) of section 6715(c) is amended by inserting "or kerosene" after "diesel fuel".

(12)(A) The text of section 7232 is amended by striking "gasoline, lubricating oil, diesel fuel" and inserting "any taxable fuel (as defined in section 4083)".

(B) The section heading for section 7232 is amended to read as follows:

"SEC. 7232. FAILURE TO REGISTER UNDER SECTION 4101, FALSE REPRESENTATIONS OF REGISTRATION STATUS, ETC."

(C) The table of sections for part II of subchapter A of chapter 75 is amended by striking the item relating to section 7232 and inserting the following:

"Sec. 7232. Failure to register under section 4101, false representations of registration status, etc."

(13) Sections 9503(b)(1)(E) and 9508(b)(2) are each amended by striking "and diesel fuel" and inserting ", diesel fuel, and kerosene".

(14) Subparagraph (B) of section 9503(b)(5) is amended by striking "or diesel fuel" and inserting ", diesel fuel, or kerosene".

(15) Paragraphs (1)(B) and (2) of section 9503(f) are each amended by inserting "or kerosene" after "diesel fuel" each place it appears.

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on July 1, 1998.

(f) FLOOR STOCK TAXES.—

(1) IMPOSITION OF TAX.—In the case of kerosene which is held on July 1, 1998, by any person, there is hereby imposed a floor stocks tax of 24.3 cents per gallon.

(2) LIABILITY FOR TAX AND METHOD OF PAYMENT.—

(A) LIABILITY FOR TAX.—A person holding kerosene on July 1, 1998, to which the tax imposed by paragraph (1) applies shall be liable for such tax.

(B) METHOD OF PAYMENT.—The tax imposed by paragraph (1) shall be paid in such manner as the Secretary shall prescribe.

(C) TIME FOR PAYMENT.—The tax imposed by paragraph (1) shall be paid on or before August 31, 1998.

(3) DEFINITIONS.—For purposes of this subsection—

(A) HELD BY A PERSON.—Kerosene shall be considered as "held by a person" if title thereto has passed to such person (whether or not delivery to the person has been made).

(B) SECRETARY.—The term "Secretary" means the Secretary of the Treasury or his delegate.

(4) EXCEPTION FOR EXEMPT USES.—The tax imposed by paragraph (1) shall not apply to kerosene held by any person exclusively for any use to the extent a credit or refund of the tax imposed by section 4081 of the Internal Revenue Code of 1986 is allowable for such use.

(5) EXCEPTION FOR FUEL HELD IN VEHICLE TANK.—No tax shall be imposed by paragraph (1) on kerosene held in the tank of a motor vehicle or motorboat.

(6) EXCEPTION FOR CERTAIN AMOUNTS OF FUEL.—

(A) IN GENERAL.—No tax shall be imposed by paragraph (1) on kerosene held on July 1, 1998, by any person if the aggregate amount of kerosene held by such person on such date does not exceed 2,000 gallons. The preceding sentence shall apply only if such person submits to the Secretary (at the time and in the manner required by the Secretary) such information as the Secretary shall require for purposes of this paragraph.

(B) EXEMPT FUEL.—For purposes of subparagraph (A), there shall not be taken into account fuel held by any person which is exempt from the tax imposed by paragraph (1) by reason of paragraph (4) or (5).

(C) CONTROLLED GROUPS.—For purposes of this paragraph—

(i) CORPORATIONS.—

(I) IN GENERAL.—All persons treated as a controlled group shall be treated as 1 person.

(II) CONTROLLED GROUP.—The term "controlled group" has the meaning given to such term by subsection (a) of section 1563 of such Code; except that for such purposes the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in such subsection.

(ii) NONINCORPORATED PERSONS UNDER COMMON CONTROL.—Under regulations prescribed by the Secretary, principles similar to the principles of clause (i) shall apply to a group of persons under common control where 1 or more of such persons is not a corporation.

(7) COORDINATION WITH SECTION 4081.—No tax shall be imposed by paragraph (1) on kerosene to the extent that tax has been (or will be) imposed on such kerosene under section 4081 or 4091 of such Code.

(8) OTHER LAWS APPLICABLE.—All provisions of law, including penalties, applicable with respect to the taxes imposed by section 4081 of such Code shall, insofar as applicable and not inconsistent with the provisions of this subsection, apply with respect to the floor stock taxes imposed by paragraph (1) to the same extent as if such taxes were imposed by such section 4081.

SEC. 1043. REDUCTION OF INCENTIVES FOR ALCOHOL FUELS.

(a) DENIAL OF CREDIT FOR ALCOHOL USED TO PRODUCE ETHER.—Subsection (b) of section 40 is amended by adding at the end the following new paragraph:

"(6) DENIAL OF CREDIT FOR ALCOHOL USED TO PRODUCE ETHER.—No credit shall be allowed under this section for alcohol used to produce any ether."

(b) LIMITATION ON ALCOHOL ELIGIBLE FOR CREDIT FOR ALCOHOL USED AS FUEL—

(1) IN GENERAL.—Subparagraph (A) of section 40(d)(1) (defining alcohol) is amended by striking "or" at the end of clause (i), by striking the period at the end of clause (ii) and inserting ", or", and by adding at the end the following new clause:

"(iii) alcohol produced by a still (or other distilling apparatus) placed in service after June 8, 1997."

(2) FUTURE CREDIT LIMITED TO AVERAGE HISTORICAL PRODUCTION.—Section 40 is amended by adding at the end the following new subsection:

"(i) EXPANDED PRODUCTION INELIGIBLE FOR CREDIT.—

"(1) IN GENERAL.—Subsection (a) shall apply to alcohol produced after December 31, 1997, only if the alcohol is designated under this subsection by a producer who is registered under section 4101.

"(2) DESIGNATION BASED ON HISTORICAL PRODUCTION.—

"(A) IN GENERAL.—The amount of alcohol produced by a producer during any calendar year which may be designated under this subsection by any producer other than an eligible small ethanol producer is the amount equal to the average annual amount of alcohol (as defined in subsection (d)(1)(A) without regard to clause (iii))—

"(i) which was produced by such producer (other than casual off-farm production) during each of the base period years, and

"(ii) which was sold or used by such producer for any purpose described in clause (i) of subsection (b)(4)(B).

For purposes of the preceding sentence, a rule similar to the rule of subsection (b)(4)(D) shall apply.

"(B) BASE PERIOD YEAR.—For purposes of subparagraph (A), the term 'base period year' means each of 3 years which are among the 5-year period ending on May 31, 1997, determined by disregarding—

"(i) one year for which the production described in subparagraph (A)(i) was the largest, and

"(ii) one year for which the production described in subparagraph (A)(i) was the smallest.

"(3) PRODUCTION FOR LESS THAN ENTIRE BASE PERIOD.—If alcohol is produced by a producer for less than 3 base period years, the average referred to in paragraph (2) shall be treated as being not less than 50 percent of the annual productive capacity of such producer as of June 8, 1997.

"(4) ACQUISITIONS AND DISPOSITIONS.—Rules similar to the rules of subparagraphs (A) and (B) of section 41(f)(3) shall apply for purposes of this subsection."

(3) CONFORMING AMENDMENT.—Paragraph (1) of section 40(g) is amended by striking "clauses (i) and (ii)" and inserting "clauses (i), (ii), and (iii)".

(c) REDUCTION OF CREDIT FOR ETHANOL BY REASON OF CARBON DIOXIDE BYPRODUCT BENEFIT.—

(1) Subsection (h) of section 40 is amended—

(A) by striking "54 cents" each place it appears and inserting "51 cents", and

(B) by striking "40 cents" each place it appears and inserting "38.25 cents".

(2) Subparagraph (A) of section 4041(b)(2) is amended by striking "5.4 cents" and inserting "5.1 cents".

(3) Paragraphs (4)(A) and (5) of section 4081(c) are each amended by striking "5.4 cents" each place it appears and inserting "5.1 cents".

(4) Paragraph (1) of section 4091(c) is amended by striking "13.4 cents" and inserting "13.1 cents".

(d) EXCISE TAX ON EXCESS PRODUCTION OF FUEL ALCOHOL.—

(1) IN GENERAL.—Chapter 36 (relating to certain other excise taxes) is amended by inserting after subchapter B the following new subchapter:

"Subchapter C—Excess Production of Fuel Alcohol

"Sec. 4476. Imposition of tax.

"SEC. 4476. IMPOSITION OF TAX.

"(a) GENERAL RULE.—There is hereby imposed a tax of 51 cents for each gallon of excess fuel alcohol produced, imported, or brought into the United States.

"(b) LIABILITY FOR TAX.—The tax imposed by subsection (a) shall be paid by the person who would be liable for the tax imposed by section 5001 on the alcohol but for paragraph (1)(C) or (12) of section 5214(a).

"(c) EXCESS FUEL ALCOHOL.—For purposes of this section—

"(1) DOMESTIC PRODUCTION.—In the case of alcohol produced in the United States, the term 'excess fuel alcohol' means any alcohol—

"(A) which is withdrawn free of tax under paragraph (1)(C) or (12) of section 5214(a) during any calendar year, and

"(B) which is not designated under section 40(i).

"(2) OTHER PRODUCTION.—In the case of alcohol imported or brought into the United States—

"(A) IN GENERAL.—The term 'excess fuel alcohol' means, with respect to the person importing or bringing such alcohol into the United States, the excess of—

"(i) the amount of alcohol so imported or brought into the United States by such person during any year, over

"(ii) such person's historical average determined under rules similar to the rules of section 40(i)(2).

"(B) EXCEPTION.—Such term shall not include any alcohol which the person importing or bringing such alcohol into the United States establishes to the satisfaction of the Secretary that such alcohol is not to be used as a fuel or in a mixture to be used as a fuel.

"(3) ALCOHOL.—The term 'alcohol' includes methanol and ethanol but does not include alcohol produced from petroleum, natural gas, or coal (including lignite).

"(d) SPECIAL RULES.—

"(1) EXCEPTION FOR CASUAL OFF-FARM PRODUCTION.—The tax imposed by this section shall not apply to casual off-farm production (within the meaning of section 40).

"(2) ALCOHOL MUST BE WITHDRAWN FOR FUEL USE.—Alcohol withdrawn free of tax under section 5214(a)(1)(C) shall be taken into account under this section only if withdrawn for fuel use.

"(3) CERTAIN RULES TO APPLY.—The tax imposed by this section shall attach, and be determined and paid, as if it were tax imposed by section 5001.

"(e) APPLICATION OF TAX DEPENDENT ON AVAILABILITY OF OTHER FUEL ALCOHOL SUBSIDIES.—

"(1) APPLICATION IF FUEL ALCOHOL SUBSIDIES CONTINUE.—Paragraphs (1)(B) and (2)(A)(ii) of subsection (c) shall not apply after December 31, 2000, if this section is in effect after such date.

"(2) APPLICATION IF FUEL ALCOHOL SUBSIDIES TERMINATE.—This section shall not apply after December 31, 2000, if none of the fuel alcohol subsidies apply to any sale or use after such date. For purposes of the preceding sentence, the fuel alcohol subsidies are sections 40, 4041(b)(2), 4081(c), 4091(c), 6427(f), and 6427(q)."

(2) TAX TO BE NONDEDUCTIBLE.—Subsection (a) of section 275 is amended by adding at the end the following new paragraph:

"(7) Taxes imposed by section 4476 (relating to excess production of fuel alcohol)."

(3) TAX TO BE DEPOSITED INTO HIGHWAY TRUST FUND.—Paragraph (1) of section 9503(b) is amended by striking "and" at the end of subparagraph (E), by redesignating subparagraph (F) as subparagraph (G), and by inserting after subparagraph (E) the following new subparagraph:

"(F) section 4476 (relating to excess production of fuel alcohol), and".

(4) CLERICAL AMENDMENT.—The table of subchapters for chapter 36 is amended by inserting after the item relating to subchapter B the following new item:

"Subchapter C. Excess production of fuel alcohol."

(e) INCREASE IN SMALL ETHANOL PRODUCER CREDIT.—Subparagraph (A) of section 40(b)(4) is amended by striking "10 cents" and inserting "13 cents".

(f) EFFECTIVE DATE.—

(1) AMENDMENTS RELATING TO CREDIT.—The amendments made by subsections (a), (b), (c)(1), and (e) shall apply to alcohol produced after December 31, 1997, in taxable years ending after such date.

(2) AMENDMENTS RELATING TO EXCISE TAXES.—The amendments made by subsections (c)(2) and (d) shall take effect on January 1, 1998.

(3) STILLS PLACED IN SERVICE PURSUANT TO BINDING CONTRACTS.—For purposes of subsections (d)(1)(A)(iii) and (i)(3) of section 40 of the Internal Revenue Code of 1986, as amended by this section, a still (or other distilling apparatus) shall be treated as placed in service before June 9, 1997, if such still (or other apparatus) is constructed or acquired by the taxpayer pursuant to a written contract which was binding on June 8, 1997, and at all times thereafter before such construction or acquisition.

SEC. 1044. RESTORATION OF LEAKING UNDERGROUND STORAGE TANK TRUST FUND TAXES.

Paragraph (3) of section 4081(d) is amended by striking "shall not apply after December 31, 1995" and inserting "shall apply after the date of the enactment of the Revenue Reconciliation Act of 1997 and before October 1, 2002".

SEC. 1045. APPLICATION OF COMMUNICATIONS TAX TO LONG-DISTANCE PREPAID TELEPHONE CARDS.

(a) IN GENERAL.—Subsection (b) of section 4251 is amended—

(1) by adding at the end the following new paragraph:

"(3) LONG-DISTANCE PREPAID TELEPHONE CARDS AND SIMILAR ARRANGEMENTS.—Any amount paid (and the value of any other benefit provided) to a provider of communications services (or any related person) for the right to award, sell, or otherwise make available telephone service (or reductions in the cost of such service) other than local telephone service through prepaid telephone cards or any similar arrangement shall be treated as an amount paid for communications services. The Secretary shall prescribe rules which reallocate items of income, deduction, credit, exclusion, or other allowance to the extent necessary to prevent the avoidance of tax imposed by reason of this paragraph.", and

(2) by inserting "AND SPECIAL RULE" after "DEFINITIONS" in the heading.

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to amounts paid on or after the date of the enactment of this Act.

(2) PAYMENTS WITHIN CONTROLLED GROUP.—For purposes of paragraph (1), any amount paid after June 11, 1997, and before the date of the enactment of this Act by 1 member of a controlled group for a right which is described in section 4251(b)(3) of the Internal Revenue Code of 1986 (as added by this section) and is furnished by another member of such group shall be treated as paid on the date of the enactment of this Act. For purposes of the preceding sentence, all persons treated as a single employer under subsection (a) or (b) of section 52 of such Code shall be treated as members of a controlled group.

Subtitle F—Provisions Relating to Tax-Exempt Entities

SEC. 1051. EXPANSION OF LOOK-THRU RULE FOR INTEREST, ANNUITIES, ROYALTIES, AND RENTS DERIVED BY SUBSIDIARIES OF TAX-EXEMPT ORGANIZATIONS.

(a) IN GENERAL.—Paragraph (13) of section 512(b) is amended to read as follows:

"(13) SPECIAL RULES FOR CERTAIN AMOUNTS RECEIVED FROM CONTROLLED ENTITIES.—

"(A) IN GENERAL.—If an organization (in this paragraph referred to as the 'controlling organization') receives (directly or indirectly) a specified payment from another entity which it controls (in this paragraph referred to as the 'controlled entity'), notwithstanding paragraphs (1), (2), and (3), the controlling organization shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

"(B) NET UNRELATED INCOME OR LOSS.—For purposes of this paragraph—

"(i) NET UNRELATED INCOME.—The term 'net unrelated income' means—

"(I) in the case of a controlled entity which is not exempt from tax under section 501(a), the portion of such entity's taxable income which would be unrelated business taxable income if such entity were exempt from tax under section 501(a) and had the same exempt purposes (as defined in section 513A(a)(5)(A)) as the controlling organization, or

"(II) in the case of a controlled entity which is exempt from tax under section 501(a), the amount of the unrelated business taxable income of the controlled entity.

"(ii) NET UNRELATED LOSS.—The term 'net unrelated loss' means the net operating loss adjusted under rules similar to the rules of clause (i).

"(C) SPECIFIED PAYMENT.—For purposes of this paragraph, the term 'specified payment' means any interest, annuity, royalty, or rent.

"(D) DEFINITION OF CONTROL.—For purposes of this paragraph—

"(i) CONTROL.—The term 'control' means—

"(I) in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation,

"(II) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership, or

"(III) in any other case, ownership of more than 50 percent of the beneficial interests in the entity.

"(ii) CONSTRUCTIVE OWNERSHIP.—Section 318 (relating to constructive ownership of stock) shall apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity.

"(E) RELATED PERSONS.—The Secretary shall prescribe such rules as may be necessary or appropriate to prevent avoidance of the purposes of this paragraph through the use of related persons."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

(2) CONTROL TEST.—In the case of taxable years beginning before January 1, 1999, an organization shall be treated as controlling another organization for purposes of section 512(b)(13) of the Internal Revenue Code of 1986 (as amended by this section) only if it controls such organization within the meaning of such section, determined by substituting "80 percent" for "50 percent" each place it appears in subparagraph (D) thereof.

SEC. 1052. LIMITATION ON INCREASE IN BASIS OF PROPERTY RESULTING FROM SALE BY TAX-EXEMPT ENTITY TO A RELATED PERSON.

(a) IN GENERAL.—Part IV of subchapter O of chapter 1 (relating to special rules for gain or loss on disposition of property) is amended by redesignating section 1061 as section 1062 and by inserting after section 1060 the following new section:

"SEC. 1061. BASIS LIMITATION FOR SALE OR EXCHANGE OF PROPERTY BY TAX-EXEMPT ENTITY TO RELATED PERSON.

"(a) GENERAL RULE.—In the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property acquired shall not exceed the adjusted basis of such property (immediately before the exchange) in the hands of the tax-exempt entity, increased by the amount of gain recognized to the tax-exempt entity on the transfer which is subject to tax under section 511.

"(b) DEFINITIONS.—For purposes of this section—

"(1) TAX-EXEMPT ENTITY.—The term 'tax-exempt entity' means any entity which is exempt from the tax imposed by this chapter.

"(2) RELATED PERSON.—The term 'related person' means any person bearing a relationship to the tax-exempt entity which is described in section 267(b) or 707(b)(1). For purposes of applying section 267(b)(2) under the preceding sentence, such an entity shall be treated as if it were an individual."

(b) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter O of chapter 1 is amended by striking the last item and inserting the following:

"Sec. 1061. Basis limitation for sale or exchange of property by tax-exempt entity to related person.
"Sec. 1062. Cross references."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to sales and exchanges after June 8, 1997.

(2) BINDING CONTRACTS.—The amendments made by this section shall not apply to any sale or exchange pursuant to a written contract which was binding on June 8, 1997, and at all times thereafter before the sale or exchange.

SEC. 1053. MODIFICATIONS TO EXCEPTION FROM REPORTING, ETC. OF LOBBYING ACTIVITIES.

(a) IN GENERAL.—Paragraph (3) of section 6033(e) (relating to exception where dues generally nondeductible) is amended to read as follows:

"(3) EXCEPTION WHERE DUES GENERALLY NONDEDUCTIBLE.—

"(A) IN GENERAL.—Paragraph (1)(A) shall not apply to an organization if more than 90 percent of the amount of the aggregate annual dues (or similar payments) paid to such organization are paid—

"(i) by individuals or families whose annual dues (or similar amounts) are less than $100, or

"(ii) by organizations which are exempt from tax.

For purposes of the preceding sentence, all organizations sharing a name, charter, historic affiliation, or similar characteristics and coordinating their lobbying activities shall be treated as 1 organization.

"(B) INFLATION ADJUSTMENT.—In the case of dues for annual periods beginning in any calendar year after 1998, the dollar amount contained in subparagraph (A)(i) shall be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any increase determined under the preceding sentence is not a multiple of $5, such increase shall be rounded to the nearest multiple of $5."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

SEC. 1054. TERMINATION OF CERTAIN EXCEPTIONS FROM RULES RELATING TO EXEMPT ORGANIZATIONS WHICH PROVIDE COMMERCIAL-TYPE INSURANCE.

(a) IN GENERAL.—Subparagraphs (A) and (B) of section 1012(c)(4) of the Tax Reform Act of 1986 shall not apply to any taxable year beginning after December 31, 1997.

(b) SPECIAL RULES.—In the case of an organization to which section 501(m) of the Internal Revenue Code of 1986 applies solely by reason of the amendment made by subsection (a)—

(1) no adjustment shall be made under section 481 (or any other provision) of such Code on account of a change in its method of accounting for its first taxable year beginning after December 31, 1997, and

(2) for purposes of determining gain or loss, the adjusted basis of any asset held on the 1st day of such taxable year shall be treated as equal to its fair market value as of such day.

(c) RESERVE WEAKENING AFTER JUNE 8, 1997.—Any reserve weakening after June 8, 1997, by an organization described in subsection (b) shall be treated as occurring in such organizations 1st taxable year beginning after December 31, 1997.

(d) REGULATIONS.—The Secretary of the Treasury or his delegate may prescribe rules for providing proper adjustments for organizations described in subsection (b) with respect to short taxable years which begin during 1998 by reason of section 843 of the Internal Revenue Code of 1986.

Subtitle G—Other Revenue Provisions

SEC. 1061. TERMINATION OF SUSPENSE ACCOUNTS FOR FAMILY CORPORATIONS REQUIRED TO USE ACCRUAL METHOD OF ACCOUNTING.

(a) IN GENERAL.—Subsection (i) of section 447 (relating to method of accounting for corporations engaged in farming) is amended by adding at the end the following new paragraph:

"(7) TERMINATION.—

"(A) IN GENERAL.—No suspense account may be established under this subsection by any corporation required by this section to change its method of accounting for any taxable year ending after June 8, 1997.

"(B) PHASEOUT OF EXISTING SUSPENSE ACCOUNTS.—

"(i) IN GENERAL.—Each suspense account under this subsection shall be reduced (but not below zero) for each taxable year beginning after June 8, 1997, by an amount equal to the lesser of—

"(I) the applicable portion of such account, or

"(II) 50 percent of the taxable income of the corporation for the taxable year, or, if the corporation has no taxable income for such year, the amount of any net operating loss (as defined in section 172(c)) for such taxable year.

For purposes of the preceding sentence, the amount of taxable income and net operating loss shall be determined without regard to this paragraph.

"(ii) COORDINATION WITH OTHER REDUCTIONS.—The amount of the applicable portion for any taxable year shall be reduced (but not below zero) by the amount of any reduction required for such taxable year under any other provision of this subsection.

"(iv) INCLUSION IN INCOME.—Any reduction in a suspense account under this paragraph shall be included in gross income for the taxable year of the reduction.

"(C) APPLICABLE PORTION.—For purposes of subparagraph (B), the term 'applicable portion' means, for any taxable year, the amount which would ratably reduce the amount in the account (after taking into account prior reductions) to zero over the period consisting of such taxable year and the remaining taxable years in such first 20 taxable years.

"(D) AMOUNTS AFTER 20TH YEAR.—Any amount in the account as of the close of the 20th year referred to in subparagraph (C) shall be treated as the applicable portion for each succeeding year thereafter to the extent not reduced under this paragraph for any prior taxable year after such 20th year."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after June 8, 1997.

SEC. 1062. MODIFICATION OF TAXABLE YEARS TO WHICH NET OPERATING LOSSES MAY BE CARRIED.

(a) IN GENERAL.—Subparagraph (A) of section 172(b)(1) (relating to years to which loss may be carried) is amended—

(1) by striking "3" in clause (i) and inserting "2", and

(2) by striking "15" in clause (ii) and inserting "20".

(b) RETENTION OF 3-YEAR CARRYBACK FOR CASUALTY LOSSES OF INDIVIDUALS.—Paragraph (1) of section 172(b) is amended by adding at the end the following new subparagraph:

"(F) CASUALTY LOSSES OF INDIVIDUALS.—Subparagraph (A)(i) shall be applied by substituting '3 years' for '2 years' with respect to the portion of the net operating loss of an individual for the taxable year which is attributable to losses of property arising from fire, storm, shipwreck, or other casualty, or from theft."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to net operating losses for taxable years beginning after the date of the enactment of this Act.

SEC. 1063. EXPANSION OF DENIAL OF DEDUCTION FOR CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE.

(a) DENIAL OF DEDUCTION FOR PREMIUMS.—Paragraph (1) of section 264(a) is amended to read as follows:

"(1) 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."

(b) INTEREST ON POLICY LOANS.—Paragraph (4) of section 264(a) is amended by striking "individual, who" and all that follows and inserting "individual."

(c) PRO RATA ALLOCATION OF INTEREST EXPENSE TO POLICY CASH VALUES.—Section 264 is amended by adding at the end the following new subsection:

"(e) PRO RATA ALLOCATION OF INTEREST EXPENSE TO POLICY CASH VALUES.—

"(1) IN GENERAL.—No deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash values.

"(2) ALLOCATION.—For purposes of paragraph (1), the portion of the taxpayer's interest expense which is allocable to unborrowed policy cash values is an amount which bears the same ratio to such interest expense as—

"(A) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, bears to

"(B) the average adjusted bases (within the meaning of section 1016) for all assets of the taxpayer.

"(3) UNBORROWED POLICY CASH VALUES.—The term 'unborrowed policy cash value' means, with respect to any life insurance policy or annuity or endowment contract, the excess of—

"(A) the cash surrender value of such policy or contract determined without regard to any surrender charge, over

"(B) the amount of any loan in respect of such policy or contract.

"(4) EXCEPTION FOR CERTAIN POLICIES AND CONTRACTS COVERING OFFICERS, DIRECTORS, AND EMPLOYEES.—Paragraph (1) shall not apply to any policy or contract owned by an entity engaged in a trade or business which covers any individual who is an officer, director, or employee of such trade or business at the time first covered by the policy or contract, and such policies and contracts shall not be taken into account under paragraph (2).

"(5) EXCEPTION FOR POLICIES AND CONTRACTS HELD BY NATURAL PERSONS; TREATMENT OF PARTNERSHIPS AND S CORPORATIONS.—

"(A) POLICIES AND CONTRACTS HELD BY NATURAL PERSONS.—

"(i) IN GENERAL.—This subsection shall not apply to any policy or contract held by a natural person.

"(ii) EXCEPTION WHERE BUSINESS IS BENEFICIARY.—If a trade or business is directly or indirectly the beneficiary under any policy or contract, to the extent of the unborrowed cash value of such policy or contract, such policy or contract shall be treated as held by such trade or business and not by a natural person.

"(iii) SPECIAL RULES.—

"(I) CERTAIN TRADES OR BUSINESSES NOT TAKEN INTO ACCOUNT.—Clause (ii) shall not apply to any trade or business carried on as a sole proprietorship and to any trade or business performing services as an employee.

"(II) LIMITATION ON UNBORROWED CASH VALUE.—The amount of the unborrowed cash value of any policy or contract which is taken into account by reason of clause (ii) shall not exceed the benefit to which the trade or business is entitled under the policy or contract.

"(iv) REPORTING.—The Secretary shall require such reporting from policyholders and issuers as is necessary to carry out clause (ii). Any report required under the preceding sentence shall be treated as a statement referred to in section 6724(d)(1).

"(B) TREATMENT OF PARTNERSHIPS AND S CORPORATIONS.—In the case of a partnership or S corporation, this subsection shall be applied at the partnership and corporate levels.

"(6) SPECIAL RULES.—

"(A) COORDINATION WITH SUBSECTION (a) AND SECTION 265.—If interest on any indebtedness is disallowed under subsection (a) or section 265—

"(i) such disallowed interest shall not be taken into account for purposes of applying this subsection, and

"(ii) for purposes of applying paragraph (2)(B), the adjusted bases otherwise taken into account shall be reduced (but not below zero) by the amount of such indebtedness.

"(B) COORDINATION WITH SECTION 263A.—This subsection shall be applied before the application of section 263A (relating to capitalization of certain expenses where taxpayer produces property)."

"(7) INTEREST EXPENSE.—The term 'interest expense' means the aggregate amount allowable to the taxpayer as a deduction for interest (within the meaning of section 265(b)(4)) for the taxable year (determined without regard to this subsection, section 265(b), and section 291).

"(8) AGGREGATION RULES.—

"(A) IN GENERAL.—All members of a controlled group (within the meaning of subsection (d)(5)(B)) shall be treated as 1 taxpayer for purposes of this subsection.

"(B) TREATMENT OF INSURANCE COMPANIES.—This subsection shall not apply to an insurance company, and subparagraph (A) shall be applied without regard to any insurance company."

(b) TREATMENT OF INSURANCE COMPANIES.—

(1) Clause (ii) of section 805(a)(4)(C) is amended by inserting ", or out of the increase for the taxable year in policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies" after "tax-exempt interest".

(2) Clause (iii) of section 805(a)(4)(D) is amended by striking "and" and inserting ", the increase for the taxable year in policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies, and".

(3) Subparagraph (B) of section 807(a)(2) is amended by striking "interest," and inserting "interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies,".

(4) Subparagraph (B) of section 807(b)(1) is amended by striking "interest," and inserting "interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies,".

(5) Paragraph (1) of section 812(d) is amended by striking "and" at the end of subparagraph (B), by striking the period at the end of subparagraph (C) and inserting ", and", and by adding at the end the following new subparagraph:

"(D) the increase for any taxable year in the policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies."

(6) Subparagraph (B) of section 832(b)(5) is amended by striking "and" at the end of clause (i), by striking the period at the end of clause (ii) and inserting ", and", and by adding at the end the following new clause:

"(iii) the increase for the taxable year in policy cash values (within the meaning of section 264(e)(3)(A)) of life insurance policies and annuity and endowment contracts to which section 264(e) applies."

(c) CONFORMING AMENDMENT.—Subparagraph (A) of section 265(b)(4) is amended by inserting ", section 264," before "and section 291".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to contracts issued after June 8, 1997, in taxable years ending after such date. For purposes of the preceding sentence, any material increase in the death benefit or other material change in the contract shall be treated as a new contract but the addition of covered lives shall be treated as a new contract only with respect to such additional covered lives. For purposes of this subsection, an increase in the death benefit under a policy or contract issued in connection with a lapse described in section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 shall not be treated as a new contract.

SEC. 1064. ALLOCATION OF BASIS AMONG PROPERTIES DISTRIBUTED BY PARTNERSHIP.

(a) IN GENERAL.—Subsection (c) of section 732 is amended to read as follows:

"(c) ALLOCATION OF BASIS.—

"(1) IN GENERAL.—The basis of distributed properties to which subsection (a)(2) or (b) is applicable shall be allocated—

"(A)(i) first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership, and

"(ii) if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, then, to the extent any decrease is required in order to have the adjusted bases of such properties equal the basis to be allocated, in the manner provided in paragraph (3), and

"(B) to the extent of any basis not allocated under subparagraph (A), to other distributed properties—

"(i) first by assigning to each such other property such other property's adjusted basis to the partnership, and

"(ii) then, to the extent any increase or decrease in basis is required in order to have the adjusted bases of such other distributed properties equal such remaining basis, in the manner provided in paragraph (2) or (3), whichever is appropriate.

"(2) METHOD OF ALLOCATING INCREASE.—Any increase required under paragraph (1)(B) shall be allocated among the properties—

"(A) first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and

"(B) then, to the extent such increase is not allocated under subparagraph (A), in proportion to their respective fair market values.

"(3) METHOD OF ALLOCATING DECREASE.—Any decrease required under paragraph (1)(A) or (1)(B) shall be allocated—

"(A) first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), and

"(B) then, to the extent such decrease is not allocated under subparagraph (A), in proportion to their respective adjusted bases (as adjusted under subparagraph (A))."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions after the date of the enactment of this Act.

SEC. 1065. REPEAL OF REQUIREMENT THAT INVENTORY BE SUBSTANTIALLY APPRECIATED.

(a) IN GENERAL.—Paragraph (2) of section 751(a) is amended to read as follows:

"(2) inventory items of the partnership,".

(b) CONFORMING AMENDMENTS.—

(1) Subsection (d) of section 751 is amended to read as follows:

"(d) INVENTORY ITEMS.—For purposes of this subchapter, the term 'inventory items' means—

"(1) property of the partnership of the kind described in section 1221(1), "(2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231,

"(3) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and

"(4) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in paragraph (1), (2), or (3)."

(2) Sections 724(d)(2), 731(a)(2)(B), 731(c)(6), 732(c)(1)(A) (as amended by the preceding section), 735(a)(2), and 735(c)(1) are each amended by striking "section 751(d)(2)" and inserting "section 751(d)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales, exchanges, and distributions after the date of the enactment of this Act.

SEC. 1066. EXTENSION OF TIME FOR TAXING PRECONTRIBUTION GAIN.

(a) IN GENERAL.—Sections 704(c)(1)(B) and 737(b)(1) are each amended by striking "5 years" and inserting "10 years".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to property contributed to a partnership after June 8, 1997.

SEC. 1067. RESTRICTIONS ON AVAILABILITY OF EARNED INCOME CREDIT FOR TAXPAYERS WHO IMPROPERLY CLAIMED CREDIT IN PRIOR YEAR.

(a) IN GENERAL.—Section 32 is amended by redesignating subsections (k) and (l) as subsections (l) and (m), respectively, and by inserting after subsection (j) the following new subsection:

"(k) RESTRICTIONS ON TAXPAYERS WHO IMPROPERLY CLAIMED CREDIT IN PRIOR YEAR.—

"(1) TAXPAYERS MAKING PRIOR FRAUDULENT OR RECKLESS CLAIMS.—

"(A) IN GENERAL.—No credit shall be allowed under this section for any taxable year in the disallowance period.

"(B) DISALLOWANCE PERIOD.—For purposes of paragraph (1), the disallowance period is—

"(i) the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to fraud, and

"(ii) the period of 2 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

"(2) TAXPAYERS MAKING IMPROPER PRIOR CLAIMS.—In the case of a taxpayer who is denied credit under this section for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no credit shall be allowed under this section for any subsequent taxable year unless the taxpayer provides such information as the Secretary may require to demonstrate eligibility for such credit."

(b) Due Diligence Requirement on Income Tax Return Preparers.—Section 6695 is amended by adding at the end the following new subsection:

"(g) Failure To Be Diligent in Determining Eligibility for Earned Income Credit.—Any person who is an income tax preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of $100 for each such failure."

(c) Extension Procedures Applicable to Mathematical or Clerical Errors.—Paragraph (2) of section 6213(g) (relating to the definition of mathematical or clerical errors) is amended by striking "and" at the end of subparagraph (H), by striking the period at the end of subparagraph (I) and inserting ", and", and by inserting after subparagraph (I) the following new subparagraph:

"(J) an omission of information required by section 32(k)(2) (relating to taxpayers making improper prior claims of earned income credit)."

(d) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1996.

SEC. 1068. LIMITATION ON PROPERTY FOR WHICH INCOME FORECAST METHOD MAY BE USED.

(a) Limitation.—Subsection (g) of section 167 is amended by adding at the end the following new paragraph:

"(6) Limitation on property for which income forecast method may be used.—The depreciation deduction allowable under this section may be determined under the income forecast method or any similar method only with respect to—

"(A) property described in paragraph (3) or (4) of section 168(f),

"(B) copyrights,

"(C) books,

"(D) patents, and

"(E) other property specified in regulations.

Such methods may not be used with respect to any amortizable section 197 intangible (as defined in section 197(c))."

(b) Depreciation Period for Rent-To-Own Property.—

(1) In general.—Subparagraph (A) of section 168(e)(3) (relating to 3-year property) is amended by striking "and" at the end of clause (i), by striking the period at the end of clause (ii) and inserting ", and", and by adding at the end the following new clause:

"(iii) any qualified rent-to-own property."

(2) 4-year class life.—The table contained in section 168(g)(3)(B) is amended by inserting before the first item the following new item:

"(A)(iii)	4"

(3) Definition of qualified rent-to-own property.—Subsection (i) of section 168 is amended by adding at the end the following new paragraph:

"(14) Qualified rent-to-own property.—

“(A) IN GENERAL.—The term ‘qualified rent-to-own property’ means property held by a rent-to-own dealer for purposes of being subject to a rent-to-own contract.

“(B) RENT-TO-OWN DEALER.—The term ‘rent-to-own dealer’ means a person that, in the ordinary course of business, regularly enters into rent-to-own contracts with customers for the use of consumer property, if a substantial portion of those contracts terminate and the property is returned to such person before the receipt of all payments required to transfer ownership of the property from such person to the customer.

“(C) CONSUMER PROPERTY.—The term ‘consumer property’ means tangible personal property of a type generally used within the home. Such term shall not include cellular telephones and any computer or peripheral equipment (as defined in section 168(i)).

“(D) RENT-TO-OWN CONTRACT.—The term ‘rent-to-own contract’ means any lease for the use of consumer property between a rent-to-own dealer and a customer who is an individual which—

“(i) is titled ‘Rent-to-Own Agreement’ or ‘Lease Agreement with Ownership Option,’ or uses other similar language,

“(ii) provides for level, regular periodic payments (for a payment period which is a week or month),

“(iii) provides that legal title to such property remains with the rent-to-own dealer until the customer makes all the payments described in clause (ii) or early purchase payments required under the contract to acquire legal title to the item of property,

“(iv) provides a beginning date and a maximum period of time for which the contract may be in effect that does not exceed 156 weeks or 36 months from such beginning date (including renewals or options to extend),

“(v) provides for level payments within the 156-week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer property plus interest,

“(vi) provides for payments under the contract that, in the aggregate, do not exceed $10,000 per item of consumer property,

“(vii) provides that the customer does not have any legal obligation to make all the payments referred to in clause (ii) set forth under the contract, and that at the end of each payment period the customer may either continue to use the consumer property by making the payment for the next payment period or return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract, and "(viii) provides that the customer has no right to sell, sublease, mortgage, pawn, pledge, encumber, or otherwise dispose of the consumer property until all the payments stated in the contract have been made."

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to property placed in service after the date of the enactment of this Act.

SEC. 1069. REPEAL OF SPECIAL RULE FOR RENTAL USE OF VACATION HOMES, ETC., FOR LESS THAN 15 DAYS.

(a) IN GENERAL.—Section 280A (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended by striking subsection (g).

(b) NO BASIS REDUCTION UNLESS DEPRECIATION CLAIMED.—Section 1016 is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) SPECIAL RULE WHERE RENTAL USE OF VACATION HOME, ETC., FOR LESS THAN 15 DAYS.—If a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, the reduction under subsection (a)(2) by reason of such rental use in any taxable year beginning after December 31, 1997, shall not exceed the depreciation deduction allowed for such rental use."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1070. EXPANSION OF REQUIREMENT THAT INVOLUNTARILY CONVERTED PROPERTY BE REPLACED WITH PROPERTY ACQUIRED FROM AN UNRELATED PERSON.

(a) IN GENERAL.—Subsection (i) of section 1033 is amended to read as follows:

"(i) REPLACEMENT PROPERTY MUST BE ACQUIRED FROM UNRELATED PERSON IN CERTAIN CASES.—

"(1) IN GENERAL.—If the property which is involuntarily converted is held by a taxpayer to which this subsection applies, subsection (a) shall not apply if the replacement property or stock is acquired from a related person. The preceding sentence shall not apply to the extent that the related person acquired the replacement property or stock from an unrelated person during the period applicable under subsection (a)(2)(B).

"(2) TAXPAYERS TO WHICH SUBSECTION APPLIES.—This subsection shall apply to—

"(A) a C corporation,

"(B) a partnership in which 1 or more C corporations own, directly or indirectly (determined in accordance with section 707(b)(3)), more than 50 percent of the capital interest, or profits interest, in such partnership at the time of the involuntary conversion, and

"(C) any other taxpayer if, with respect to property which is involuntarily converted during the taxable year, the aggregate of the amount of realized gain on such property on which there is realized gain exceeds $100,000.

In the case of a partnership, subparagraph (C) shall apply with respect to the partnership and with respect to each partner. A similar rule shall apply in the case of an S corporation and its shareholders.

"(3) RELATED PERSON.—For purposes of this subsection, a person is related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to involuntary conversions occurring after June 8, 1997.

SEC. 1071. TREATMENT OF EXCEPTION FROM INSTALLMENT SALES RULES FOR SALES OF PROPERTY BY A MANUFACTURER TO A DEALER.

(a) IN GENERAL.—Paragraph (2) of section 811(c) of the Tax Reform Act of 1986 is hereby repealed.

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

(2) COORDINATION WITH SECTION 481.—In the case of any taxpayer required by this section to change its method of accounting for any taxable year—

(A) such changes shall be treated as initiated by the taxpayer,

(B) such changes shall be treated as made with the consent of the Secretary, and

(C) the net amount of the adjustments required to be taken into account under section 481(a) of the Internal Revenue Code of 1986 shall be taken into account ratably over the 4 taxable year period beginning with the first taxable year beginning after the date of the enactment of this Act.

TITLE XI—SIMPLIFICATION AND OTHER FOREIGN-RELATED PROVISIONS

Subtitle A—General Provisions

SEC. 1101. TREATMENT OF COMPUTER SOFTWARE AS FSC EXPORT PROPERTY.

(a) IN GENERAL.—Subparagraph (B) of section 927(a)(2) (relating to property excluded from eligibility as FSC export property) is amended by inserting ", and other than computer software (whether or not patented)" before ", for commercial or home use".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to gross receipts attributable to periods after December 31, 1997, in taxable years ending after such date.

(c) PHASEIN OF TREATMENT.—For purposes of the Internal Revenue Code of 1986—

(1) 1998.—In the case of gross receipts attributable to calendar year 1998, the amendment made by subsection (a) shall apply to only ⅓ of such gross receipts.

(2) 1999.—In the case of gross receipts attributable to calendar year 1999, the amendment made by subsection (a) shall apply to only ⅔ of such gross receipts.

SEC. 1102. ADJUSTMENT OF DOLLAR LIMITATION ON SECTION 911 EXCLUSION.

(a) General Rule.—Paragraph (2) of section 911(b) is amended by—

(1) by striking "of $70,000" in subparagraph (A) and inserting "equal to the exclusion amount for the calendar year in which such taxable year begins", and

(2) by adding at the end the following new subparagraph:

"(D) Exclusion amount.—

"(i) In general.—The exclusion amount for any calendar year is the exclusion amount determined in accordance with the following table (as adjusted by clause (ii)):

"For calendar year—	**The exclusion amount is—**
1998	$72,000
1999	74,000
2000	76,000
2001	78,000
2002 and thereafter	80,000.

"(ii) Inflation adjustment.—In the case of any taxable year beginning in a calendar year after 2007, the $80,000 amount in clause (i) shall be increased by an amount equal to the product of—

"(I) such dollar amount, and

"(II) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting '2006' for '1992' in subparagraph (B) thereof.

If any increase determined under the preceding sentence is not a multiple of $100, such increase shall be rounded to the next lowest multiple of $100."

(b) Effective Date.—The amendment made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1103. CERTAIN INDIVIDUALS EXEMPT FROM FOREIGN TAX CREDIT LIMITATION.

(a) General Rule.—Section 904 (relating to limitations on foreign tax credit) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) Certain Individuals Exempt.—

"(1) In general.—In the case of an individual to whom this subsection applies for any taxable year—

"(A) the limitation of subsection (a) shall not apply,

"(B) no taxes paid or accrued by the individual during such taxable year may be deemed paid or accrued under subsection (c) in any other taxable year, and

"(C) no taxes paid or accrued by the individual during any other taxable year may be deemed paid or accrued under subsection (c) in such taxable year.

"(2) Individuals to whom subsection applies.—This subsection shall apply to an individual for any taxable year if—

"(A) the entire amount of such individual's gross income for the taxable year from sources without the United States consists of qualified passive income, "(B) the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year does not exceed $300 ($600 in the case of a joint return), and

"(C) such individual elects to have this subsection apply for the taxable year.

"(3) DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFIED PASSIVE INCOME.—The term 'qualified passive income' means any item of gross income if—

"(i) such item of income is passive income (as defined in subsection (d)(2)(A) without regard to clause (iii) thereof), and

"(ii) such item of income is shown on a payee statement furnished to the individual.

"(B) CREDITABLE FOREIGN TAXES.—The term 'creditable foreign taxes' means any taxes for which a credit is allowable under section 901; except that such term shall not include any tax unless such tax is shown on a payee statement furnished to such individual.

"(C) PAYEE STATEMENT.—The term 'payee statement' has the meaning given to such term by section 6724(d)(2).

"(D) ESTATES AND TRUSTS NOT ELIGIBLE.—This subsection shall not apply to any estate or trust."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

SEC. 1104. EXCHANGE RATE USED IN TRANSLATING FOREIGN TAXES.

(a) ACCRUED TAXES TRANSLATED BY USING AVERAGE RATE FOR YEAR TO WHICH TAXES RELATE.—

(1) IN GENERAL.—Subsection (a) of section 986 (relating to translation of foreign taxes) is amended to read as follows:

"(a) FOREIGN INCOME TAXES.—

"(1) TRANSLATION OF ACCRUED TAXES.—

"(A) IN GENERAL.—For purposes of determining the amount of the foreign tax credit, in the case of a taxpayer who takes foreign income taxes into account when accrued, the amount of any foreign income taxes (and any adjustment thereto) shall be translated into dollars by using the average exchange rate for the taxable year to which such taxes relate.

"(B) EXCEPTION FOR CERTAIN TAXES.—Subparagraph (A) shall not apply to any foreign income taxes—

"(i) paid after the date 2 years after the close of the taxable year to which such taxes relate, or

"(ii) paid before the beginning of the taxable year to which such taxes relate.

"(C) EXCEPTION FOR INFLATIONARY CURRENCIES.—Subparagraph (A) shall not apply to any foreign income taxes the liability for which is denominated in any inflationary currency (as determined under regulations).

"(D) CROSS REFERENCE.—

"For adjustments where tax is not paid within 2 years, see section 905(c).

"(2) TRANSLATION OF TAXES TO WHICH PARAGRAPH (1) DOES NOT APPLY.—For purposes of determining the amount of the foreign tax credit, in the case of any foreign income taxes to which subparagraph (A) of paragraph (1) does not apply—

"(A) such taxes shall be translated into dollars using the exchange rates as of the time such taxes were paid to the foreign country or possession of the United States, and

"(B) any adjustment to the amount of such taxes shall be translated into dollars using—

"(i) except as provided in clause (ii), the exchange rate as of the time when such adjustment is paid to the foreign country or possession, or

"(ii) in the case of any refund or credit of foreign income taxes, using the exchange rate as of the time of the original payment of such foreign income taxes.

"(3) FOREIGN INCOME TAXES.—For purposes of this subsection, the term 'foreign income taxes' means any income, war profits, or excess profits taxes paid or accrued to any foreign country or to any possession of the United States."

(2) ADJUSTMENT WHEN NOT PAID WITHIN 2 YEARS AFTER YEAR TO WHICH TAXES RELATE.—Subsection (c) of section 905 is amended to read as follows:

"(c) ADJUSTMENTS TO ACCRUED TAXES.—

"(1) IN GENERAL.—If—

"(A) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer,

"(B) accrued taxes are not paid before the date 2 years after the close of the taxable year to which such taxes relate, or

"(C) any tax paid is refunded in whole or in part,

the taxpayer shall notify the Secretary, who shall redetermine the amount of the tax for the year or years affected. The Secretary may prescribe adjustments to tax pools under sections 902 and 960 in lieu of the redetermination under the preceding sentence.

"(2) SPECIAL RULE FOR TAXES NOT PAID WITHIN 2 YEARS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), in making the redetermination under paragraph (1), no credit shall be allowed for accrued taxes not paid before the date referred to in subparagraph (B) of paragraph (1).

"(B) TAXES SUBSEQUENTLY PAID.—Any such taxes if subsequently paid shall be taken into account for the taxable year to which such taxes relate (and translated as provided in section 986(a)(2)(A)).

"(3) ADJUSTMENTS.—The amount of tax (if any) due on any redetermination under paragraph (1) shall be paid by the taxpayer on notice and demand by the Secretary, and the amount of tax overpaid (if any) shall be credited or refunded to the taxpayer in accordance with subchapter B of chapter 66 (section 6511 et seq.).

"(4) BOND REQUIREMENTS.—In the case of any tax accrued but not paid, the Secretary, as a condition precedent to the allowance of the credit provided in this subpart, may require the taxpayer to give a bond, with sureties satisfactory to and approved by the Secretary, in such sum as the Secretary may require, conditioned on the payment by the taxpayer of any amount of tax found due on any such redetermination. Any such bond shall contain such further conditions as the Secretary may require.

"(5) OTHER SPECIAL RULES.—In any redetermination under paragraph (1) by the Secretary of the amount of tax due from the taxpayer for the year or years affected by a refund, the amount of the taxes refunded for which credit has been allowed under this section shall be reduced by the amount of any tax described in section 901 imposed by the foreign country or possession of the United States with respect to such refund; but no credit under this subpart, or deduction under section 164, shall be allowed for any taxable year with respect to any such tax imposed on the refund. No interest shall be assessed or collected on any amount of tax due on any redetermination by the Secretary, resulting from a refund to the taxpayer, for any period before the receipt of such refund, except to the extent interest was paid by the foreign country or possession of the United States on such refund for such period."

(b) AUTHORITY TO USE AVERAGE RATES.—

(1) IN GENERAL.—Subsection (a) of section 986 (as amended by subsection (a)) is amended by redesignating paragraph (3) as paragraph (4) and inserting after paragraph (2) the following new paragraph:

"(3) AUTHORITY TO PERMIT USE OF AVERAGE RATES.—To the extent prescribed in regulations, the average exchange rate for the period (specified in such regulations) during which the taxes or adjustment is paid may be used instead of the exchange rate as of the time of such payment."

(2) DETERMINATION OF AVERAGE RATES.—Subsection (c) of section 989 is amended by striking "and" at the end of paragraph (4), by striking the period at the end of paragraph (5) and inserting ", and", and by adding at the end thereof the following new paragraph:

"(6) setting forth procedures for determining the average exchange rate for any period."

(3) CONFORMING AMENDMENTS.—Subsection (b) of section 989 is amended by striking "weighted" each place it appears.

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by subsections (a)(1) and (b) shall apply to taxes paid or accrued in taxable years beginning after December 31, 1997.

(2) SUBSECTION (a)(2).—The amendment made by subsection (a)(2) shall apply to taxes which relate to taxable years beginning after December 31, 1997.

SEC. 1105. ELECTION TO USE SIMPLIFIED SECTION 904 LIMITATION FOR ALTERNATIVE MINIMUM TAX.

(a) GENERAL RULE.—Subsection (a) of section 59 (relating to alternative minimum tax foreign tax credit) is amended by adding at the end thereof the following new paragraph:

"(3) ELECTION TO USE SIMPLIFIED SECTION 904 LIMITATION.—

"(A) IN GENERAL.—In determining the alternative minimum tax foreign tax credit for any taxable year to which an election under this paragraph applies—

"(i) subparagraph (B) of paragraph (1) shall not apply, and

"(ii) the limitation of section 904 shall be based on the proportion which—

"(I) the taxpayer's taxable income (as determined for purposes of the regular tax) from sources without the United States (but not in excess of the taxpayer's entire alternative minimum taxable income), bears to

"(II) the taxpayer's entire alternative minimum taxable income for the taxable year.

"(B) ELECTION.—

"(i) IN GENERAL.—An election under this paragraph may be made only for the taxpayer's first taxable year which begins after December 31, 1997, and for which the taxpayer claims an alternative minimum tax foreign tax credit.

"(ii) ELECTION REVOCABLE ONLY WITH CONSENT.—An election under this paragraph, once made, shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1106. TREATMENT OF PERSONAL TRANSACTIONS BY INDIVIDUALS UNDER FOREIGN CURRENCY RULES.

(a) GENERAL RULE.—Subsection (e) of section 988 (relating to application to individuals) is amended to read as follows:

"(e) APPLICATION TO INDIVIDUALS.—

"(1) IN GENERAL.—The preceding provisions of this section shall not apply to any section 988 transaction entered into by an individual which is a personal transaction.

"(2) EXCLUSION FOR CERTAIN PERSONAL TRANSACTIONS.—If—

"(A) nonfunctional currency is disposed of by an individual in any transaction, and

"(B) such transaction is a personal transaction,

no gain shall be recognized for purposes of this subtitle by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition. The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds $200.

"(3) PERSONAL TRANSACTIONS.—For purposes of this subsection, the term 'personal transaction' means any transaction entered into by an individual, except that such term shall not include any transaction to the extent that expenses properly allocable to such transaction meet the requirements of section 162 or 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes)."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1107. ALL NONCONTROLLED SECTION 902 CORPORATIONS WHICH ARE NOT PASSIVE FOREIGN INVESTMENT COMPANIES IN ONE FOREIGN TAX LIMITATION BASKET.

(a) IN GENERAL.—Subparagraph (E) of section 904(d)(2) (relating to noncontrolled section 902 corporations) is amended by adding at the end the following new clause:

"(iv) ALL NON-PFIC'S TREATED AS ONE.—All noncontrolled section 902 corporations which are not passive foreign investment companies (as defined in section 1297) shall be treated as one noncontrolled section 902 corporation for purposes of paragraph (1). The Secretary may prescribe regulations regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2001.

Subtitle B—Treatment of Controlled Foreign Corporations

SEC. 1111. GAIN ON CERTAIN STOCK SALES BY CONTROLLED FOREIGN CORPORATIONS TREATED AS DIVIDENDS.

(a) GENERAL RULE.—Section 964 (relating to miscellaneous provisions) is amended by adding at the end thereof the following new subsection:

"(e) GAIN ON CERTAIN STOCK SALES BY CONTROLLED FOREIGN CORPORATIONS TREATED AS DIVIDENDS.—

"(1) IN GENERAL.—If a controlled foreign corporation sells or exchanges stock in any other foreign corporation, gain recognized on such sale or exchange shall be included in the gross income of such controlled foreign corporation as a dividend to the same extent that it would have been so included under section 1248(a) if such controlled foreign corporation were a United States person. For purposes of determining the amount which would have been so includible, the determination of whether such other foreign corporation was a controlled foreign corporation shall be made without regard to the preceding sentence.

"(2) SAME COUNTRY EXCEPTION NOT APPLICABLE.—Clause (i) of section 954(c)(3)(A) shall not apply to any amount treated as a dividend by reason of paragraph (1).

"(3) CLARIFICATION OF DEEMED SALES.—For purposes of this subsection, a controlled foreign corporation shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such controlled foreign corporation is treated as having gain from the sale or exchange of such stock."

(b) AMENDMENT OF SECTION 904(d).—Clause (i) of section 904(d)(2)(E) is amended by striking "and except as provided in regulations, the taxpayer was a United States shareholder in such corporation".

(c) EFFECTIVE DATES.—

(1) The amendment made by subsection (a) shall apply to gain recognized on transactions occurring after the date of the enactment of this Act.

(2) The amendment made by subsection (b) shall apply to distributions after the date of the enactment of this Act.

SEC. 1112. MISCELLANEOUS MODIFICATIONS TO SUBPART F.

(a) SECTION 1248 GAIN TAKEN INTO ACCOUNT IN DETERMINING PRO RATA SHARE.—

(1) IN GENERAL.—Paragraph (2) of section 951(a) (defining pro rata share of subpart F income) is amended by adding at the end thereof the following new sentence: "For purposes of subparagraph (B), any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to dispositions after the date of the enactment of this Act.

(b) BASIS ADJUSTMENTS IN STOCK HELD BY FOREIGN CORPORATION.—

(1) IN GENERAL.—Section 961 (relating to adjustments to basis of stock in controlled foreign corporations and of other property) is amended by adding at the end thereof the following new subsection:

"(c) BASIS ADJUSTMENTS IN STOCK HELD BY FOREIGN CORPORATION.—Under regulations prescribed by the Secretary, if a United States shareholder is treated under section 958(a)(2) as owning any stock in a controlled foreign corporation which is actually owned by another controlled foreign corporation, adjustments similar to the adjustments provided by subsections (a) and (b) shall be made to the basis of such stock in the hands of such other controlled foreign corporation, but only for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder (or any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder by reason of which such shareholder was treated as owning such stock, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary may prescribe by regulations)."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply for purposes of determining inclusions for taxable years of United States shareholders beginning after December 31, 1997.

(c) CLARIFICATION OF TREATMENT OF BRANCH TAX EXEMPTIONS OR REDUCTIONS.—

(1) IN GENERAL.—Subsection (b) of section 952 is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, any exemption (or reduction) with respect to the tax imposed by section 884 shall not be taken into account.".

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall apply to taxable years beginning after December 31, 1986.

SEC. 1113. INDIRECT FOREIGN TAX CREDIT ALLOWED FOR CERTAIN LOWER TIER COMPANIES.

(a) SECTION 902 CREDIT.—

(1) IN GENERAL.—Subsection (b) of section 902 (relating to deemed taxes increased in case of certain 2nd and 3rd tier foreign corporations) is amended to read as follows:

"(b) DEEMED TAXES INCREASED IN CASE OF CERTAIN LOWER TIER CORPORATIONS.—

"(1) IN GENERAL.—If—

"(A) any foreign corporation is a member of a qualified group, and

"(B) such foreign corporation owns 10 percent or more of the voting stock of another member of such group from which it receives dividends in any taxable year,

such foreign corporation shall be deemed to have paid the same proportion of such other member's post-1986 foreign income taxes as would be determined under subsection (a) if such foreign corporation were a domestic corporation.

"(2) QUALIFIED GROUP.—For purposes of paragraph (1), the term 'qualified group' means—

"(A) the foreign corporation described in subsection (a), and

"(B) any other foreign corporation if—

"(i) the domestic corporation owns at least 5 percent of the voting stock of such other foreign corporation indirectly through a chain of foreign corporations connected through stock ownership of at least 10 percent of their voting stock,

"(ii) the foreign corporation described in subsection (a) is the first tier corporation in such chain, and

"(iii) such other corporation is not below the sixth tier in such chain.

The term 'qualified group' shall not include any foreign corporation below the third tier in the chain referred to in clause (i) unless such foreign corporation is a controlled foreign corporation (as defined in section 957) and the domestic corporation is a United States shareholder (as defined in section 951(b)) in such foreign corporation. Paragraph (1) shall apply to those taxes paid by a member of the qualified group below the third tier only with respect to periods during which it was a controlled foreign corporation."

(2) CONFORMING AMENDMENTS.—

(A) Subparagraph (B) of section 902(c)(3) is amended by adding "or" at the end of clause (i) and by striking clauses (ii) and (iii) and inserting the following new clause:

"(ii) the requirements of subsection (b)(2) are met with respect to such foreign corporation."

(B) Subparagraph (B) of section 902(c)(4) is amended by striking "3rd foreign corporation" and inserting "sixth tier foreign corporation".

(C) The heading for paragraph (3) of section 902(c) is amended by striking "WHERE DOMESTIC CORPORATION ACQUIRES 10 PERCENT OF FOREIGN CORPORATION" and inserting "WHERE FOREIGN CORPORATION FIRST QUALIFIES".

(D) Paragraph (3) of section 902(c) is amended by striking "ownership" each place it appears.

(b) SECTION 960 CREDIT.—Paragraph (1) of section 960(a) (relating to special rules for foreign tax credits) is amended to read as follows:

"(1) DEEMED PAID CREDIT.—For purposes of subpart A of this part, if there is included under section 951(a) in the gross income of a domestic corporation any amount attributable to earnings and profits of a foreign corporation which is a member of a qualified group (as defined in section 902(b)) with respect to the domestic corporation, then, except to the extent provided in regulations, section 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B))."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxes of foreign corporations for taxable years of such corporations beginning after the date of enactment of this Act.

(2) SPECIAL RULE.—In the case of any chain of foreign corporations described in clauses (i) and (ii) of section 902(b)(2)(B) of the Internal Revenue Code of 1986 (as amended by this section), no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of the enactment of this Act shall have the effect of permitting taxes to be taken into account under section 902 of the Internal Revenue Code of 1986 which could not have been taken into account under such section but for such transaction.

Subtitle C—Treatment of Passive Foreign Investment Companies

SEC. 1121. UNITED STATES SHAREHOLDERS OF CONTROLLED FOREIGN CORPORATIONS NOT SUBJECT TO PFIC INCLUSION.

Section 1296 is amended by adding at the end the following new subsection:

"(e) EXCEPTION FOR UNITED STATES SHAREHOLDERS OF CONTROLLED FOREIGN CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this part, a corporation shall not be treated with respect to a shareholder as a passive foreign investment company during the qualified portion of such shareholder's holding period with respect to stock in such corporation.

"(2) QUALIFIED PORTION.—For purposes of this subsection, the term 'qualified portion' means the portion of the shareholder's holding period—

"(A) which is after December 31, 1997, and

"(B) during which the shareholder is a United States shareholder (as defined in section 951(b)) of the corporation and the corporation is a controlled foreign corporation.

"(3) NEW HOLDING PERIOD IF QUALIFIED PORTION ENDS.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), if the qualified portion of a shareholder's holding period with respect to any stock ends after December 31, 1997, solely for purposes of this part, the shareholder's holding period with respect to such stock shall be treated as beginning as of the first day following such period.

"(B) EXCEPTION.—Subparagraph (A) shall not apply if such stock was, with respect to such shareholder, stock in a passive foreign investment company at any time before the qualified portion of the shareholder's holding period with respect to such stock and no election under section 1298(b)(1) is made."

SEC. 1122. ELECTION OF MARK TO MARKET FOR MARKETABLE STOCK IN PASSIVE FOREIGN INVESTMENT COMPANY.

(a) IN GENERAL.—Part VI of subchapter P of chapter 1 is amended by redesignating subpart C as subpart D, by redesignating sections 1296 and 1297 as sections 1297 and 1298, respectively, and by inserting after subpart B the following new subpart:

"Subpart C—Election of Mark to Market For Marketable Stock

"Sec. 1296. Election of mark to market for marketable stock.

"SEC. 1296. ELECTION OF MARK TO MARKET FOR MARKETABLE STOCK.

"(a) GENERAL RULE.—In the case of marketable stock in a passive foreign investment company which is owned (or treated under subsection (g) as owned) by a United States person at the close of any taxable year of such person, at the election of such person—

"(1) If the fair market value of such stock as of the close of such taxable year exceeds its adjusted basis, such United States person shall include in gross income for such taxable year an amount equal to the amount of such excess.

"(2) If the adjusted basis of such stock exceeds the fair market value of such stock as of the close of such taxable year, such United States person shall be allowed a deduction for such taxable year equal to the lesser of—

"(A) the amount of such excess, or

"(B) the unreversed inclusions with respect to such stock.

"(b) BASIS ADJUSTMENTS.—

"(1) IN GENERAL.—The adjusted basis of stock in a passive foreign investment company—

"(A) shall be increased by the amount included in the gross income of the United States person under subsection (a)(1) with respect to such stock, and

"(B) shall be decreased by the amount allowed as a deduction to the United States person under subsection (a)(2) with respect to such stock.

"(2) SPECIAL RULE FOR STOCK CONSTRUCTIVELY OWNED.—In the case of stock in a passive foreign investment company which the United States person is treated as owning under subsection (g)—

"(A) the adjustments under paragraph (1) shall apply to such stock in the hands of the person actually holding such stock but only for purposes of determining the subsequent treatment under this chapter of the United States person with respect to such stock, and

"(B) similar adjustments shall be made to the adjusted basis of the property by reason of which the United States person is treated as owning such stock.

"(c) CHARACTER AND SOURCE RULES.—

"(1) ORDINARY TREATMENT.—

"(A) GAIN.—Any amount included in gross income under subsection (a)(1), and any gain on the sale or other disposition of marketable stock in a passive foreign investment company (with respect to which an election under this section is in effect), shall be treated as ordinary income.

"(B) LOSS.—Any—

"(i) amount allowed as a deduction under subsection (a)(2), and

"(ii) loss on the sale or other disposition of marketable stock in a passive foreign investment company (with respect to which an election under this section is in effect) to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to such stock,

shall be treated as an ordinary loss. The amount so treated shall be treated as a deduction allowable in computing adjusted gross income.

"(2) SOURCE.—The source of any amount included in gross income under subsection (a)(1) (or allowed as a deduction under subsection (a)(2)) shall be determined in the same manner as if such amount were gain or loss (as the case may be) from the sale of stock in the passive foreign investment company.

"(d) UNREVERSED INCLUSIONS.—For purposes of this section, the term 'unreversed inclusions' means, with respect to any stock in a passive foreign investment company, the excess (if any) of—

"(1) the amount included in gross income of the taxpayer under subsection (a)(1) with respect to such stock for prior taxable years, over

"(2) the amount allowed as a deduction under subsection (a)(2) with respect to such stock for prior taxable years.

The amount referred to in paragraph (1) shall include any amount which would have been included in gross income under subsection (a)(1) with respect to such stock for any prior taxable year but for section 1291.

"(e) MARKETABLE STOCK.—For purposes of this section—

"(1) IN GENERAL.—The term 'marketable stock' means—

"(A) any stock which is regularly traded on—

"(i) a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or "(ii) any exchange or other market which the Secretary determines has rules adequate to carry out the purposes of this part,

"(B) to the extent provided in regulations, stock in any foreign corporation which is comparable to a regulated investment company and which offers for sale or has outstanding any stock of which it is the issuer and which is redeemable at its net asset value, and

"(C) to the extent provided in regulations, any option on stock described in subparagraph (A) or (B).

"(2) SPECIAL RULE FOR REGULATED INVESTMENT COMPANIES.—In the case of any regulated investment company which is offering for sale or has outstanding any stock of which it is the issuer and which is redeemable at its net asset value, all stock in a passive foreign investment company which it owns directly or indirectly shall be treated as marketable stock for purposes of this section. Except as provided in regulations, similar treatment as marketable stock shall apply in the case of any other regulated investment company which publishes net asset valuations at least annually.

"(f) TREATMENT OF CONTROLLED FOREIGN CORPORATIONS WHICH ARE SHAREHOLDERS IN PASSIVE FOREIGN INVESTMENT COMPANIES.—In the case of a foreign corporation which is a controlled foreign corporation and which owns (or is treated under subsection (g) as owning) stock in a passive foreign investment company—

"(1) this section (other than subsection (c)(2)) shall apply to such foreign corporation in the same manner as if such corporation were a United States person, and

"(2) for purposes of subpart F of part III of subchapter N—

"(A) any amount included in gross income under subsection (a)(1) shall be treated as foreign personal holding company income described in section 954(c)(1)(A), and

"(B) any amount allowed as a deduction under subsection (a)(2) shall be treated as a deduction allocable to foreign personal holding company income so described.

"(g) STOCK OWNED THROUGH CERTAIN FOREIGN ENTITIES.—Except as provided in regulations—

"(1) IN GENERAL.—For purposes of this section, stock owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

"(2) TREATMENT OF CERTAIN DISPOSITIONS.—In any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of paragraph (1)—

"(A) any disposition by the United States person or by any other person which results in the United States person being treated as no longer owning such stock, and

"(B) any disposition by the person owning such stock,

shall be treated as a disposition by the United States person of the stock in the passive foreign investment company.

"(h) COORDINATION WITH SECTION 851(b).—For purposes of paragraphs (2) and (3) of section 851(b), any amount included in gross income under subsection (a) shall be treated as a dividend.

"(i) STOCK ACQUIRED FROM A DECEDENT.—In the case of stock of a passive foreign investment company which is acquired by bequest, devise, or inheritance (or by the decedent's estate) and with respect to which an election under this section was in effect as of the date of the decedent's death, notwithstanding section 1014, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis which would have been determined under section 1014 without regard to this subsection).

"(j) COORDINATION WITH SECTION 1291 FOR FIRST YEAR OF ELECTION.—

"(1) TAXPAYERS OTHER THAN REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—If the taxpayer elects the application of this section with respect to any marketable stock in a corporation after the beginning of the taxpayer's holding period in such stock, and if the requirements of subparagraph (B) are not satisfied, section 1291 shall apply to—

"(i) any distributions with respect to, or disposition of, such stock in the first taxable year of the taxpayer for which such election is made, and

"(ii) any amount which, but for section 1291, would have been included in gross income under subsection (a) with respect to such stock for such taxable year in the same manner as if such amount were gain on the disposition of such stock.

"(B) REQUIREMENTS.—The requirements of this subparagraph are met if, with respect to each of such corporation's taxable years for which such corporation was a passive foreign investment company and which begin after December 31, 1986, and included any portion of the taxpayer's holding period in such stock, such corporation was treated as a qualified electing fund under this part with respect to the taxpayer.

"(2) SPECIAL RULES FOR REGULATED INVESTMENT COMPANIES.—

"(A) IN GENERAL.—If a regulated investment company elects the application of this section with respect to any marketable stock in a corporation after the beginning of the taxpayer's holding period in such stock, then, with respect to such company's first taxable year for which such company elects the application of this section with respect to such stock—

"(i) section 1291 shall not apply to such stock with respect to any distribution or disposition during, or amount included in gross income under this section for, such first taxable year, but

"(ii) such regulated investment company's tax under this chapter for such first taxable year shall be increased by the aggregate amount of interest which would have been determined under section 1291(c)(3) if section 1291 were applied without regard to this subparagraph.

Clause (ii) shall not apply if for the preceding taxable year the company elected to mark to market the stock held by such company as of the last day of such preceding taxable year.

"(B) DISALLOWANCE OF DEDUCTION.—No deduction shall be allowed to any regulated investment company for the increase in tax under subparagraph (A)(ii).

"(k) ELECTION.—This section shall apply to marketable stock in a passive foreign investment company which is held by a United States person only if such person elects to apply this section with respect to such stock. Such an election shall apply to the taxable year for which made and all subsequent taxable years unless—

"(1) such stock ceases to be marketable stock, or

"(2) the Secretary consents to the revocation of such election.

"(l) TRANSITION RULE FOR INDIVIDUALS BECOMING SUBJECT TO UNITED STATES TAX.—If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the adjusted basis (before adjustments under subsection (b)) of any marketable stock in a passive foreign investment company owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value on such first day or its adjusted basis on such first day."

(b) COORDINATION WITH INTEREST CHARGE, ETC.—

(1) Paragraph (1) of section 1291(d) is amended by adding at the end the following new flush sentence:

"Except as provided in section 1296(j), this section also shall not apply if an election under section 1296(k) is in effect for the taxpayer's taxable year."

(2) The subsection heading for subsection (d) of section 1291 is amended by striking "SUBPART B" and inserting "SUBPARTS B AND C".

(3) Subparagraph (A) of section 1291(a)(3) is amended to read as follows:

"(A) HOLDING PERIOD.—The taxpayer's holding period shall be determined under section 1223; except that—

"(i) for purposes of applying this section to an excess distribution, such holding period shall be treated as ending on the date of such distribution, and

"(ii) if section 1296 applied to such stock with respect to the taxpayer for any prior taxable year, such holding period shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied."

(c) TREATMENT OF MARK-TO-MARKET GAIN UNDER SECTION 4982.—

(1) Subsection (e) of section 4982 is amended by adding at the end thereof the following new paragraph:

"(6) TREATMENT OF GAIN RECOGNIZED UNDER SECTION 1296.—For purposes of determining a regulated investment company's ordinary income—

"(A) notwithstanding paragraph (1)(C), section 1296 shall be applied as if such company's taxable year ended on October 31, and

"(B) any ordinary gain or loss from an actual disposition of stock in a passive foreign investment company during the portion of the calendar year after October 31 shall be taken into account in determining such regulated investment company's ordinary income for the following calendar year.

In the case of a company making an election under paragraph (4), the preceding sentence shall be applied by substituting the last day of the company's taxable year for October 31."

(2) Subsection (b) of section 852 is amended by adding at the end thereof the following new paragraph:

"(10) SPECIAL RULE FOR CERTAIN LOSSES ON STOCK IN PASSIVE FOREIGN INVESTMENT COMPANY.—To the extent provided in regulations, the taxable income of a regulated investment company (other than a company to which an election under section 4982(e)(4) applies) shall be computed without regard to any net reduction in the value of any stock of a passive foreign investment company with respect to which an election under section 1296(k) is in effect occurring after October 31 of the taxable year, and any such reduction shall be treated as occurring on the first day of the following taxable year."

(3) Subsection (c) of section 852 is amended by inserting after "October 31 of such year" the following: ", without regard to any net reduction in the value of any stock of a passive foreign investment company with respect to which an election under section 1296(k) is in effect occurring after October 31 of such year,".

(d) CONFORMING AMENDMENTS.—

(1) Sections 532(b)(4) and 542(c)(10) are each amended by striking "section 1296" and inserting "section 1297".

(2) Subsection (f) of section 551 is amended by striking "section 1297(b)(5)" and inserting "section 1298(b)(5)"

(3) Subsections (a)(1) and (d) of section 1293 are each amended by striking "section 1297(a)" and inserting "section 1298(a)".

(4) Paragraph (3) of section 1297(b), as redesignated by subsection (a), is hereby repealed.

(5) The table of sections for subpart D of part VI of subchapter P of chapter 1, as redesignated by subsection (a), is amended to read as follows:

"Sec. 1297. Passive foreign investment company.
"Sec. 1298. Special rules."

(6) The table of subparts for part VI of subchapter P of chapter 1 is amended by striking the last item and inserting the following new items:

"Subpart C. Election of mark to market for marketable stock.
"Subpart D. General provisions."

(e) CLARIFICATION OF GAIN RECOGNITION ELECTION.—The last sentence of section 1298(b)(1), as so redesignated, is amended by inserting "(determined without regard to the preceding sentence)" after "investment company".

SEC. 1123. EFFECTIVE DATE.

The amendments made by this subtitle shall apply to—

(1) taxable years of United States persons beginning after December 31, 1997, and

(2) taxable years of foreign corporations ending with or within such taxable years of United States persons.

Subtitle D—Repeal of Excise Tax on Transfers to Foreign Entities

SEC. 1131. REPEAL OF EXCISE TAX ON TRANSFERS TO FOREIGN ENTITIES; RECOGNITION OF GAIN ON CERTAIN TRANSFERS TO FOREIGN TRUSTS AND ESTATES.

(a) REPEAL OF EXCISE TAX.—Chapter 5 (relating to transfers to avoid income tax) is hereby repealed.

(b) RECOGNITION OF GAIN ON CERTAIN TRANSFERS TO FOREIGN TRUSTS AND ESTATES.—Subpart F of part I of subchapter J of chapter 1 is amended by adding at the end the following new section:

"SEC. 684. RECOGNITION OF GAIN ON CERTAIN TRANSFERS TO CERTAIN FOREIGN TRUSTS AND ESTATES.

"(a) IN GENERAL.—In the case of any transfer of property by a United States person to a foreign estate or trust, for purposes of this subtitle, such transfer shall be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor shall recognize as gain the excess of—

"(1) the fair market value of the property so transferred, over

"(2) the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

"(b) EXCEPTION.—Subsection (a) shall not apply to a transfer to a trust by a United States person if such person is treated as the owner of such trust under section 671."

(c) OTHER ANTI-AVOIDANCE PROVISIONS REPLACING REPEALED EXCISE TAX.—

(1) GAIN RECOGNITION ON EXCHANGES INVOLVING FOREIGN PERSONS.—Section 1035 is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) EXCHANGES INVOLVING FOREIGN PERSONS.—To the extent provided in regulations, subsection (a) shall not apply to any exchange having the effect of transferring property to any person other than a United States person."

(2) TRANSFERS TO FOREIGN CORPORATIONS.—Section 367 is amended by adding at the end the following new subsection:

"(f) OTHER TRANSFERS.—To the extent provided in regulations, if a United States person transfers property to a foreign corporation as paid-in surplus or as a contribution to capital (in a transaction not otherwise described in this section), such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation."

(3) CERTAIN TRANSFERS TO PARTNERSHIPS.—Section 721 is amended by adding at the end the following new subsection:

"(c) REGULATIONS RELATING TO TRANSFERS TO FOREIGN PERSONS.—The Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person."

(4) REPEAL OF U.S. SOURCE TREATMENT OF DEEMED ROYALTIES.—Subparagraph (C) of section 367(d)(2) is amended to read as follows:

"(C) AMOUNTS RECEIVED TREATED AS ORDINARY INCOME.—For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income."

(5) TRANSFERS OF INTANGIBLES TO PARTNERSHIPS.—

(A) Subsection (d) of section 367 is amended by adding at the end the following new paragraph:

"(3) REGULATIONS RELATING TO TRANSFERS OF INTANGIBLES TO PARTNERSHIPS.—The Secretary may provide by regulations that the rules of paragraph (2) also apply to the transfer of intangible property by a United States person to a partnership in circumstances consistent with the purposes of this subsection."

(B) Section 721 is amended by adding at the end the following new subsection:

"(d) TRANSFERS OF INTANGIBLES.—

"For regulatory authority to treat intangibles transferred to a partnership as sold, see section 367(d)(3)."

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (h) of section 814 is amended by striking "or 1491".

(2) Section 1057 (relating to election to treat transfer to foreign trust, etc., as taxable exchange) is hereby repealed.

(3) Section 6422 is amended by striking paragraph (5) and by redesignating paragraphs (6) through (13) as paragraphs (5) through (12), respectively.

(4) The table of chapters for subtitle A is amended by striking the item relating to chapter 5.

(5) The table of sections for part IV of subchapter O of chapter 1 is amended by striking the item relating to section 1057.

(6) The table of sections for subpart F of part I of subchapter J of chapter 1 is amended by adding at the end the following new item:

"Sec. 684. Recognition of gain on certain transfers to certain foreign trusts and estates."

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

Subtitle E—Information Reporting

SEC. 1141. CLARIFICATION OF APPLICATION OF RETURN REQUIREMENT TO FOREIGN PARTNERSHIPS.

(a) IN GENERAL.—Section 6031 (relating to return of partnership income) is amended by adding at the end the following new subsection:

"(e) FOREIGN PARTNERSHIPS.—

"(1) EXCEPTION FOR FOREIGN PARTNERSHIP.—Except as provided in paragraph (2), the preceding provisions of this section shall not apply to a foreign partnership.

"(2) CERTAIN FOREIGN PARTNERSHIPS REQUIRED TO FILE RETURN.—Except as provided in regulations prescribed by the Secretary, this section shall apply to a foreign partnership for any taxable year if for such year, such partnership has—

"(A) gross income derived from sources within the United States, or

"(B) gross income which is effectively connected with the conduct of a trade or business within the United States.

The Secretary may provide simplified filing procedures for foreign partnerships to which this section applies."

(b) SANCTION FOR FAILURE BY FOREIGN PARTNERSHIP TO COMPLY WITH SECTION 6031 TO INCLUDE DENIAL OF DEDUCTIONS.—Subsection (f) of section 6231 is amended—

(1) by striking "LOSSES AND" in the heading and inserting "DEDUCTIONS, LOSSES, AND", and

(2) by striking "loss or" each place it appears and inserting "deduction, loss, or".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1142. CONTROLLED FOREIGN PARTNERSHIPS SUBJECT TO INFORMATION REPORTING COMPARABLE TO INFORMATION REPORTING FOR CONTROLLED FOREIGN CORPORATIONS.

(a) IN GENERAL.—So much of section 6038 (relating to information with respect to certain foreign corporations) as precedes paragraph (2) of subsection (a) is amended to read as follows:

"SEC. 6038. INFORMATION REPORTING WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS AND PARTNERSHIPS.

"(a) REQUIREMENT.—

"(1) IN GENERAL.—Every United States person shall furnish, with respect to any foreign business entity which such person controls, such information as the Secretary may prescribe relating to—

"(A) the name, the principal place of business, and the nature of business of such entity, and the country under whose laws such entity is incorporated (or organized in the case of a partnership);

"(B) in the case of a foreign corporation, its post-1986 undistributed earnings (as defined in section 902(c));

"(C) a balance sheet for such entity listing assets, liabilities, and capital;

"(D) transactions between such entity and—

"(i) such person,

"(ii) any corporation or partnership which such person controls, and

"(iii) any United States person owning, at the time the transaction takes place—

"(I) in the case of a foreign corporation, 10 percent or more of the value of any class of stock outstanding of such corporation, and

"(II) in the case of a foreign partnership, at least a 10-percent interest in such partnership; and

"(E)(i) in the case of a foreign corporation, a description of the various classes of stock outstanding, and a list showing the name and address of, and number of shares held by, each United States person who is a shareholder of record owning at any time during the annual accounting period 5 percent or more in value of any class of stock outstanding of such foreign corporation, and

"(ii) information comparable to the information described in clause (i) in the case of a foreign partnership.

The Secretary may also require the furnishing of any other information which is similar or related in nature to that specified in the preceding sentence or which the Secretary determines to be appropriate to carry out the provisions of this title."

(b) DEFINITIONS.—

(1) IN GENERAL.—Subsection (e) of section 6038 (relating to definitions) is amended—

(A) by redesignating paragraphs (1) and (2) as paragraphs (2) and (4), respectively,

(B) by inserting before paragraph (2) (as so redesignated) the following new paragraph:

"(1) FOREIGN BUSINESS ENTITY.—The term 'foreign business entity' means a foreign corporation and a foreign partnership.", and

(C) by inserting after paragraph (2) (as so redesignated) the following new paragraph:

"(3) PARTNERSHIP-RELATED DEFINITIONS.—

"(A) CONTROL.—A person is in control of a partnership if such person owns directly or indirectly more than a 50 percent interest in such partnership.

"(B) 50-PERCENT INTEREST.—For purposes of subparagraph (A), a 50-percent interest in a partnership is—

"(i) an interest equal to 50 percent of the capital interest, or 50 percent of the profits interest, in such partnership, or

"(ii) to the extent provided in regulations, an interest to which 50 percent of the deductions or losses of such partnership are allocated.

For purposes of the preceding sentence, rules similar to the rules of section 267(c) (other than paragraph (3)) shall apply, except so as to consider a United States person as owning such an interest which is owned by a person which is not a United States person.

"(C) 10-PERCENT INTEREST.—A 10-percent interest in a partnership is an interest which would be described in subparagraph (B) if '10 percent' were substituted for '50 percent' each place it appears."

(2) CLERICAL AMENDMENT.—The paragraph heading for paragraph (2) of section 6038(e) (as so redesignated) is amended by inserting "OF CORPORATION" after "CONTROL".

(c) MODIFICATION OF SANCTIONS ON PARTNERSHIPS AND CORPORATIONS FOR FAILURE TO FURNISH INFORMATION.—

(1) IN GENERAL.—Subsection (b) of section 6038 is amended—

(A) by striking "$1,000" each place it appears and inserting "$10,000", and

(B) by striking "$24,000" in paragraph (2) and inserting "$50,000".

(d) REPORTING BY 10-PERCENT PARTNERS.—Subsection (a) of section 6038 is amended by adding at the end the following new paragraph:

"(5) INFORMATION REQUIRED FROM 10-PERCENT PARTNER OF CONTROLLED FOREIGN PARTNERSHIP.—In the case of a foreign partnership which is controlled by United States persons holding at least 10-percent interests (but not by any one United States person), the Secretary may require each United States person who holds a 10-percent interest in such partnership to furnish information relating to such partnership, including information relating to such partner's ownership interests in the partnership and allocations to such partner of partnership items."

(e) TECHNICAL AMENDMENTS.—

(1) The following provisions of section 6038 are each amended by striking "foreign corporation" each place it appears and inserting "foreign business entity":

(A) Paragraphs (2) and (3) of subsection (a).

(B) Subsection (b).

(C) Subsection (c) other than paragraph (1)(B) thereof.

(D) Subsection (d).

(E) Subsection (e)(4) (as redesignated by subsection (b)).

(2) Subparagraph (B) of section 6038(c)(1) is amended by inserting "in the case of a foreign business entity which is a foreign corporation," after "(B)".

(3) Paragraph (8) of section 318(b) is amended by striking "6038(d)(1)" and inserting "6038(d)(2)".

(4) Paragraph (4) of section 901(k) is amended by striking "foreign corporation" and inserting "foreign corporation or partnership".

(5) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking the item relating to section 6038 and inserting the following new item:

"Sec. 6038. Information reporting with respect to certain foreign corporations and partnerships."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to annual accounting periods of foreign partnerships beginning after the date of the enactment of this Act.

SEC. 1143. MODIFICATIONS RELATING TO RETURNS REQUIRED TO BE FILED BY REASON OF CHANGES IN OWNERSHIP INTERESTS IN FOREIGN PARTNERSHIP.

(a) NO RETURN REQUIRED UNLESS CHANGES INVOLVE 10-PERCENT INTEREST IN PARTNERSHIP.—

(1) IN GENERAL.—Subsection (a) of section 6046A (relating to returns as to interests in foreign partnerships) is amended by adding at the end the following new sentence: "Paragraphs (1) and (2) shall apply to any acquisition or disposition only if the United States person directly or indirectly holds at least a 10-

percent interest in such partnership either before or after such acquisition or disposition, and paragraph (3) shall apply to any change only if the change is equivalent to at least a 10-interest in such partnership.''

(2) 10-PERCENT INTEREST.—Section 6046A is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

''(d) 10-PERCENT INTEREST.—For purposes of subsection (a), a 10-percent interest in a partnership is an interest described in section 6038(e)(3)(C).''

(b) MODIFICATION OF PENALTY ON FAILURE TO REPORT CHANGES IN OWNERSHIP INTERESTS IN FOREIGN CORPORATIONS AND PARTNERSHIPS.—Subsection (a) of section 6679 (relating to failure to file returns, etc., with respect to foreign corporations or foreign partnerships) is amended to read as follows:

''(a) CIVIL PENALTY.—

''(1) IN GENERAL.—In addition to any criminal penalty provided by law, any person required to file a return under section 6035, 6046, or 6046A who fails to file such return at the time provided in such section, or who files a return which does not show the information required pursuant to such section, shall pay a penalty of $10,000, unless it is shown that such failure is due to reasonable cause.

''(2) INCREASE IN PENALTY WHERE FAILURE CONTINUES AFTER NOTIFICATION.—If any failure described in paragraph (1) continues for more than 90 days after the day on which the Secretary mails notice of such failure to the United States person, such person shall pay a penalty (in addition to the amount required under paragraph (1)) of $10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period. The increase in any penalty under this paragraph shall not exceed $50,000.

''(3) REDUCED PENALTY FOR RETURNS RELATING TO FOREIGN PERSONAL HOLDING COMPANIES.—In the case of a return required under section 6035, paragraph (1) shall be applied by substituting '$1,000' for '$10,000', and paragraph (2) shall not apply.''

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers and changes after the date of the enactment of this Act.

SEC. 1144. TRANSFERS OF PROPERTY TO FOREIGN PARTNERSHIPS SUBJECT TO INFORMATION REPORTING COMPARABLE TO INFORMATION REPORTING FOR SUCH TRANSFERS TO FOREIGN CORPORATIONS.

(a) IN GENERAL.—Paragraph (1) of section 6038B(a) (relating to notice of certain transfers to foreign corporations) is amended to read as follows:

''(1) transfers property to—

''(A) a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361, or

''(B) a foreign partnership in a contribution described in section 721 or in any other contribution described in regulations prescribed by the Secretary,''.

(b) EXCEPTIONS.—Section 6038B is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) EXCEPTIONS FOR CERTAIN TRANSFERS TO FOREIGN PARTNERSHIPS; SPECIAL RULE.—

"(1) EXCEPTIONS.—Subsection (a)(1)(B) shall apply to a transfer by a United States person to a foreign partnership only if—

"(A) the United States person holds (immediately after the transfer) directly or indirectly at least a 10-percent interest (as defined in section 6046A(d)) in the partnership, or

"(B) the value of the property transferred (when added to the value of the property transferred by such person or any related person to such partnership or a related partnership during the 12-month period ending on the date of the transfer) exceeds $100,000.

For purposes of the preceding sentence, the value of any transferred property is its fair market value at the time of its transfer.

"(2) SPECIAL RULE.—If by reason of an adjustment under section 482 or otherwise, a contribution described in subsection (a)(1) is deemed to have been made, such contribution shall be treated for purposes of this section as having been made not earlier than the date specified by the Secretary."

(c) MODIFICATION OF PENALTY APPLICABLE TO FOREIGN CORPORATIONS AND PARTNERSHIPS.—Paragraph (1) of section 6038B(b) is amended by striking "equal to" and all that follows and inserting "equal to 10 percent of the fair market value of the property at the time of the exchange (and, in the case of a contribution described in subsection (a)(1)(B), such person shall recognize gain as if the contributed property had been sold for such value at the time of such contribution)."

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to transfers made after the date of the enactment of this Act.

(2) ELECTION OF RETROACTIVE EFFECT.—Section 1494(c) of the Internal Revenue Code of 1986 shall not apply to any transfer after August 20, 1996, if the person otherwise required to file a return with respect to such transfer elects to apply the amendments made by this section to transfers after August 20, 1996. The Secretary of the Treasury or his delegate may prescribe simplified reporting under the preceding sentence.

SEC. 1145. EXTENSION OF STATUTE OF LIMITATION FOR FOREIGN TRANSFERS.

(a) IN GENERAL.—Paragraph (8) of section 6501(c) (relating to failure to notify Secretary under section 6038B) is amended to read as follows:

"(8) FAILURE TO NOTIFY SECRETARY OF CERTAIN FOREIGN TRANSFERS.—In the case of any information which is required to be reported to the Secretary under section 6038, 6038A, 6038B, 6046, 6046A, or 6048, the time for assessment of any tax imposed by this title with respect to any event or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section.”

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to information the due date for the reporting of which is after the date of the enactment of this Act.

SEC. 1146. INCREASE IN FILING THRESHOLDS FOR RETURNS AS TO ORGANIZATION OF FOREIGN CORPORATIONS AND ACQUISITIONS OF STOCK IN SUCH CORPORATIONS.

(a) IN GENERAL.—Subsection (a) of section 6046 (relating to returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock) is amended to read as follows:

“(a) REQUIREMENT OF RETURN.—

“(1) IN GENERAL.—A return complying with the requirements of subsection (b) shall be made by—

“(A) each United States citizen or resident who becomes an officer or director of a foreign corporation if a United States person (as defined in section 7701(a)(30)) meets the stock ownership requirements of paragraph (2) with respect to such corporation,

“(B) each United States person—

“(i) who acquires stock which, when added to any stock owned on the date of such acquisition, meets the stock ownership requirements of paragraph (2) with respect to a foreign corporation, or

“(ii) who acquires stock which, without regard to stock owned on the date of such acquisition, meets the stock ownership requirements of paragraph (2) with respect to a foreign corporation,

“(C) each person (not described in subparagraph (B)) who is treated as a United States shareholder under section 953(c) with respect to a foreign corporation, and

“(D) each person who becomes a United States person while meeting the stock ownership requirements of paragraph (2) with respect to stock of a foreign corporation.

In the case of a foreign corporation with respect to which any person is treated as a United States shareholder under section 953(c), subparagraph (A) shall be treated as including a reference to each United States person who is an officer or director of such corporation.

“(2) STOCK OWNERSHIP REQUIREMENTS.—A person meets the stock ownership requirements of this paragraph with respect to any corporation if such person owns 10 percent or more of—

“(A) the total combined voting power of all classes of stock of such corporation entitled to vote, or

“(B) the total value of the stock of such corporation.”

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on January 1, 1998.

Subtitle F—Determination of Foreign or Domestic Status of Partnerships

SEC. 1151. DETERMINATION OF FOREIGN OR DOMESTIC STATUS OF PARTNERSHIPS.

(a) IN GENERAL.—Paragraph (4) of section 7701(a) is amended by inserting before the period "unless, in the case of a partnership, the partnership is more properly treated as a foreign partnership under regulations prescribed by the Secretary".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after the date of the enactment of this Act.

Subtitle G—Other Simplification Provisions

SEC. 1161. TRANSITION RULE FOR CERTAIN TRUSTS.

(a) IN GENERAL.—Paragraph (3) of section 1907(a) of the Small Business Job Protection Act of 1996 is amended by adding at the end the following flush sentence:

> "To the extent prescribed in regulations by the Secretary of the Treasury or his delegate, a trust which was in existence on August 20, 1996 (other than a trust treated as owned by the grantor under subpart E of part I of subchapter J of chapter 1 of the Internal Revenue Code of 1986), and which was treated as a United States person on the day before the date of the enactment of this Act may elect to continue to be treated as a United States person notwithstanding section 7701(a)(30)(E) of such Code."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if included in the amendments made by section 1907(a) of the Small Business Job Protection Act of 1996.

SEC. 1162. REPEAL OF STOCK AND SECURITIES SAFE HARBOR REQUIREMENT THAT PRINCIPAL OFFICE BE OUTSIDE THE UNITED STATES.

(a) IN GENERAL.—The last sentence of clause (ii) of section 864(b)(2)(A) (relating to stock or securities) is amended by striking ", or in the case of a corporation" and all that follows and inserting a period.

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

Subtitle H—Other Provisions

SEC. 1171. DEFINITION OF FOREIGN PERSONAL HOLDING COMPANY INCOME.

(a) INCOME FROM NOTIONAL PRINCIPAL CONTRACTS AND PAYMENTS IN LIEU OF DIVIDENDS.—

(1) IN GENERAL.—Paragraph (1) of section 954(c) (defining foreign personal holding company income) is amended by adding at the end the following new subparagraphs:

"(F) INCOME FROM NOTIONAL PRINCIPAL CONTRACTS.—Net income from notional principal contracts. Any item of income, gain, deduction, or loss from a notional principal contract entered into for purposes of hedging any item described in any preceding subparagraph shall not be taken into account for purposes of this subparagraph but shall be taken into account under such other subparagraph.

"(G) PAYMENTS IN LIEU OF DIVIDENDS.—Payments in lieu of dividends which are made pursuant to an agreement to which section 1058 applies."

(2) CONFORMING AMENDMENT.—Subparagraph (B) of section 954(c)(1) is amended—

(A) by striking the second sentence, and

(B) by striking "also" in the last sentence.

(b) EXCEPTION FOR DEALERS.—Paragraph (2) of section 954(c) is amended by adding at the end the following new subparagraph:

"(C) EXCEPTION FOR DEALERS.—Except as provided in subparagraph (A), (E), or (G) of paragraph (1) or by regulations, in the case of a regular dealer in property (within the meaning of paragraph (1)(B)), forward contracts, option contracts, or similar financial instruments (including notional principal contracts and all instruments referenced to commodities), there shall not be taken into account in computing foreign personal holding income any item of income, gain, deduction, or loss from any transaction (including hedging transactions) entered into in the ordinary course of such dealer's trade or business as such a dealer."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1172. PERSONAL PROPERTY USED PREDOMINANTLY IN THE UNITED STATES TREATED AS NOT PROPERTY OF A LIKE KIND WITH RESPECT TO PROPERTY USED PREDOMINANTLY OUTSIDE THE UNITED STATES.

(a) IN GENERAL.—Subsection (h) of section 1031 (relating to exchange of property held for productive use or investment) is amended to read as follows:

"(h) SPECIAL RULES FOR FOREIGN REAL AND PERSONAL PROPERTY.—For purposes of this section—

"(1) REAL PROPERTY.—Real property located in the United States and real property located outside the United States are not property of a like kind.

"(2) PERSONAL PROPERTY.—

"(A) IN GENERAL.—Personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind.

"(B) PREDOMINANT USE.—Except as provided in subparagraph (C) and (D), the predominant use of any property shall be determined based on—

"(i) in the case of the property relinquished in the exchange, the 2-year period ending on the date of such relinquishment, and "(ii) in the case of the property acquired in the exchange, the 2-year period beginning on the date of such acquisition.

"(C) PROPERTY HELD FOR LESS THAN 2 YEARS.—Except in the case of an exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection—

"(i) only the periods the property was held by the person relinquishing the property (or any related person) shall be taken into account under subparagraph (B)(i), and

"(ii) only the periods the property was held by the person acquiring the property (or any related person) shall be taken into account under subparagraph (B)(ii).

"(D) SPECIAL RULE FOR CERTAIN PROPERTY.—Property described in any subparagraph of section 168(g)(4) shall be treated as used predominantly in the United States."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by this section shall apply to transfers after June 8, 1997, in taxable years ending after such date.

(2) BINDING CONTRACTS.—The amendment made by this section shall not apply to any transfer pursuant to a written binding contract in effect on June 8, 1997, and at all times thereafter before the disposition of property. A contract shall not fail to meet the requirements of the preceding sentence solely because—

(A) it provides for a sale in lieu of an exchange, or

(B) the property to be acquired as replacement property was not identified under such contract before June 9, 1997.

SEC. 1173. HOLDING PERIOD REQUIREMENT FOR CERTAIN FOREIGN TAXES.

(a) IN GENERAL.—Section 901 is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

"(k) MINIMUM HOLDING PERIOD FOR CERTAIN TAXES.—

"(1) WITHHOLDING TAXES.—

"(A) IN GENERAL.—In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if—

"(i) such stock is held by the recipient of the dividend for 15 days or less during the 30-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

"(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

"(B) WITHHOLDING TAX.—For purposes of this paragraph, the term 'withholding tax' 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.

"(2) DEEMED PAID TAXES.—In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if—

"(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

"(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

"(3) 45-DAY RULE IN THE CASE OF CERTAIN PREFERENCE DIVIDENDS.—In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied—

"(A) by substituting '45 days' for '15 days' each place it appears, and

"(B) by substituting '90-day period' for '30-day period'.

"(4) EXCEPTION FOR CERTAIN TAXES PAID BY SECURITIES DEALERS.—

"(A) IN GENERAL.—Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a securities business of any person—

"(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

"(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or

"(iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a securities regulating authority of such country.

"(B) QUALIFIED TAX.—For purposes of subparagraph (A), the term 'qualified tax' means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if—

"(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

"(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

"(C) REGULATIONS.—The Secretary may prescribe such regulations as may be appropriate to prevent the abuse of the exception provided by this paragraph.

"(5) CERTAIN RULES TO APPLY.—For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

"(6) TREATMENT OF BONA FIDE SALES.—If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such person's holding period meets the requirements of paragraph (2) shall be made as of the date such contract is entered into.

"(7) TAXES ALLOWED AS DEDUCTION, ETC.—Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection."

(b) NOTICE OF WITHHOLDING TAXES PAID BY REGULATED INVESTMENT COMPANY.—Subsection (c) of section 853 (relating to foreign tax credit allowed to shareholders) is amended by adding at the end the following new sentence: "Such notice shall also include the amount of such taxes which (without regard to the election under this section) would not be allowable as a credit under section 901(a) to the regulated investment company by reason of section 901(k)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to dividends paid or accrued more than 30 days after the date of the enactment of this Act.

SEC. 1174. PENALTIES FOR FAILURE TO DISCLOSE POSITION THAT CERTAIN INTERNATIONAL TRANSPORTATION INCOME IS NOT INCLUDIBLE IN GROSS INCOME.

(a) IN GENERAL.—Section 883 is amended by adding at the end the following new subsection:

"(d) PENALTIES FOR FAILURE TO DISCLOSE POSITION THAT CERTAIN INTERNATIONAL TRANSPORTATION INCOME IS NOT INCLUDIBLE IN GROSS INCOME.—

"(1) IN GENERAL.—A taxpayer who, with respect to any tax imposed by this title, takes the position that any of its gross income derived from the international operation of 1 or more ships or aircraft is not includible in gross income by reason of paragraph (1) or (2) of subsection (a) or paragraph (1) or (2) of section 872(b) (or by reason of any applicable treaty) shall be entitled to such treatment only if such position is disclosed (in such manner as the Secretary may prescribe) on the return of tax for such tax (or any statement attached to such return).

"(2) ADDITIONAL PENALTIES FOR FAILING TO DISCLOSE POSITION.—If a taxpayer fails to meet the requirement of paragraph (1) for any taxable year with respect to the international operation of 1 or more ships or 1 or more aircraft—

"(A) the amount of the income from the international operation to which such failure relates—

"(i) which is from sources without the United States, and

"(ii) which is attributable to a fixed place of business in the United States,

shall be treated for purposes of this title as effectively connected with the conduct of a trade or business within the United States, and

"(B) no deductions or credits shall be allowed which are attributable to income from the international operation to which the failure relates.

"(3) REASONABLE CAUSE EXCEPTION.—This subsection shall not apply to a failure to disclose a position if it is shown that such failure is due to reasonable cause and not due to willful neglect."

(b) CONFORMING AMENDMENTS.—Paragraphs (1) and (2) of section 872(b), and paragraphs (1) and (2) of section 883(a), are each amended by striking “Gross income” each place it appears and inserting “Except as provided in section 883(d), gross income”.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

(2) COORDINATION WITH TREATIES.—The amendments made by this section shall not apply in any case where their application would be contrary to any treaty obligation of the United States.

(d) INFORMATION TO BE PROVIDED BY CUSTOMS SERVICE.—The United States Custom Service shall provide the Secretary of the Treasury or his delegate with such information as may be specified by such Secretary in order to enable such Secretary to determine whether ships which are not registered in the United States are engaged in transportation to or from the United States.

SEC. 1175. DENIAL OF TREATY BENEFITS FOR CERTAIN PAYMENTS THROUGH HYBRID ENTITIES.

A foreign person shall be entitled under any income tax treaty of the United States with a foreign country to any reduced rate of any withholding tax imposed by the Internal Revenue Code of 1986 on an item of income derived through any partnership or other pass-thru entity only to the extent that such item is treated for purposes of the taxation laws of such foreign country as an item of income of such person. The preceding sentence shall not apply if—

(1) the treaty contains a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership, or

(2) the foreign country imposes tax on a distribution of such item of income from such partnership to such person.

SEC. 1176. INTEREST ON UNDERPAYMENTS NOT REDUCED BY FOREIGN TAX CREDIT CARRYBACKS.

(a) IN GENERAL.—Subsection (d) of section 6601 is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by inserting after paragraph (1) the following new paragraph:

“(2) FOREIGN TAX CREDIT CARRYBACKS.—If any credit allowed for any taxable year is increased by reason of a carryback of tax paid or accrued to foreign countries or possessions of the United States, such increase shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which such taxes were in fact paid or accrued, or, with respect to any portion of such credit carryback from a taxable year attributable to a net operating loss carryback or a capital loss carryback from a subsequent taxable year, such increase shall not affect the computation of interest under this section for the period ending with the filing date for such subsequent taxable year.”

(b) CONFORMING AMENDMENT TO REFUNDS ATTRIBUTABLE TO FOREIGN TAX CREDIT CARRYBACKS.—

(1) IN GENERAL.—Subsection (f) of section 6611 is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) FOREIGN TAX CREDIT CARRYBACKS.—For purposes of subsection (a), if any overpayment of tax imposed by subtitle A results from a carryback of tax paid or accrued to foreign countries or possessions of the United States, such overpayment shall be deemed not to have been made before the filing date for the taxable year in which such taxes were in fact paid or accrued, or, with respect to any portion of such credit carryback from a taxable year attributable to a net operating loss carryback or a capital loss carryback from a subsequent taxable year, such overpayment shall be deemed not to have been made before the filing date for such subsequent taxable year."

(2) CONFORMING AMENDMENTS.—

(A) Paragraph (4) of section 6611(f) (as so redesignated) is amended—

(i) by striking "PARAGRAPHS (1) AND (2)" and inserting "PARAGRAPHS (1), (2), AND (3)", and

(ii) by striking "paragraph (1) or (2)" each place it appears and inserting "paragraph (1), (2), or (3)".

(B) Clause (ii) of section 6611(f)(4)(B) (as so redesignated) is amended by striking "and" at the end of subclause (I), by redesignating subclause (II) as subclause (III), and by inserting after subclause (I) the following new subclause:

"(II) in the case of a carryback of taxes paid or accrued to foreign countries or possessions of the United States, the taxable year in which such taxes were in fact paid or accrued (or, with respect to any portion of such carryback from a taxable year attributable to a net operating loss carryback or a capital loss carryback from a subsequent taxable year, such subsequent taxable year), and".

(C) Subclause (III) of section 6611(f)(4)(B)(ii) (as so redesignated) is amended by inserting "(as defined in paragraph (3)(B))" after "credit carryback" the first place it appears.

(D) Section 6611 is amended by striking subsection (g) and by redesignating subsections (h) and (i) as subsections (g) and (h), respectively.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to carrybacks arising in taxable years beginning after the date of the enactment of this Act.

SEC. 1177. CLARIFICATION OF PERIOD OF LIMITATIONS ON CLAIM FOR CREDIT OR REFUND ATTRIBUTABLE TO FOREIGN TAX CREDIT CARRYFORWARD.

(a) IN GENERAL.—Subparagraph (A) of section 6511(d)(3) is amended by striking "for the year with respect to which the claim is made" and inserting "for the year in which such taxes were actually paid or accrued".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxes paid or accrued in taxable years beginning after the date of the enactment of this Act.

SEC. 1178. MISCELLANEOUS CLARIFICATIONS.

(a) ATTRIBUTION OF DEEMED PAID FOREIGN TAXES TO PRIOR DISTRIBUTIONS.—Subparagraph (B) of section 902(c)(2) is amended by striking "deemed paid with respect to" and inserting "attributable to".

(b) FINANCIAL SERVICES INCOME DETERMINED WITHOUT REGARD TO HIGH-TAXED INCOME.—Subclause (II) of section 904(d)(2)(C)(i) is amended by striking "subclause (I)" and inserting "subclauses (I) and (III)".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

TITLE XII—SIMPLIFICATION PROVISIONS RELATING TO INDIVIDUALS AND BUSINESSES

Subtitle A—Provisions Relating to Individuals

SEC. 1201. BASIC STANDARD DEDUCTION AND MINIMUM TAX EXEMPTION AMOUNT FOR CERTAIN DEPENDENTS.

(a) BASIC STANDARD DEDUCTION.—

(1) IN GENERAL.—Paragraph (5) of section 63(c) (relating to limitation on basic standard deduction in the case of certain dependents) is amended by striking "shall not exceed" and all that follows and inserting "shall not exceed the greater of—

"(A) $500, or

"(B) the sum of $250 and such individual's earned income."

(2) CONFORMING AMENDMENT.—Paragraph (4) of section 63(c) is amended—

(A) by striking "(5)(A)" in the material preceding subparagraph (A) and inserting "(5)", and

(B) by striking "by substituting" and all that follows in subparagraph (B) and inserting "by substituting for 'calendar year 1992' in subparagraph (B) thereof—

"(i) 'calendar year 1987' in the case of the dollar amounts contained in paragraph (2) or (5)(A) or subsection (f), and

"(ii) 'calendar year 1997' in the case of the dollar amount contained in paragraph (5)(B)."

(b) MINIMUM TAX EXEMPTION AMOUNT.—Subsection (j) of section 59 is amended to read as follows:

"(j) TREATMENT OF UNEARNED INCOME OF MINOR CHILDREN.—

"(1) IN GENERAL.—In the case of a child to whom section 1(g) applies, the exemption amount for purposes of section 55 shall not exceed the sum of—

"(A) such child's earned income (as defined in section 911(d)(2)) for the taxable year, plus

"(B) $5,000.

"(2) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 1998, the dollar amount in paragraph (1)(B) shall be increased by an amount equal to the product of—

"(A) such dollar amount, and

"(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting '1997' for '1992' in subparagraph (B) thereof.

If any increase determined under the preceding sentence is not a multiple of $50, such increase shall be rounded to the nearest multiple of $50."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1202. INCREASE IN AMOUNT OF TAX EXEMPT FROM ESTIMATED TAX REQUIREMENTS.

(a) IN GENERAL.—Paragraph (1) of section 6654(e) (relating to exception where tax is small amount) is amended by striking "$500" and inserting "$1,000".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1203. OPTIONAL METHODS FOR COMPUTING SECA TAX COMBINED.

(a) INTERNAL REVENUE CODE.—

(1) IN GENERAL.—Subsection (h) of section 1402 is amended to read as follows:

"(h) OPTIONAL METHOD FOR COMPUTING SELF-EMPLOYMENT INCOME.—

"(1) INDIVIDUALS.—In the case of any trade or business which is carried on by an individual—

"(A) if the gross income derived by him from such trade or business is not more than the upper limit for the taxable year, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be 66⅔ percent of such gross income, or

"(B) if the gross income derived by him from such trade or business is more than the upper limit for the taxable year and the net earnings from self-employment derived by him from such trade or business (computed under subsection (a) without regard to this sentence) are less than the lower limit for the taxable year, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be the lower limit for the taxable year.

"(2) MEMBER OF A PARTNERSHIP.—In the case of a member of a partnership carrying on any trade or business—

"(A) if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is not more than the upper limit for the taxable year, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be an amount equal to 66⅔ percent of his distributive share of such gross income (after such gross income has been so reduced), or

"(B) if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is more than the upper limit for the taxable year and his distributive share (whether or not distributed) of income described in section 702(a)(8) derived from such trade or business (computed under this subsection without regard to this sentence) is less than the lower limit for the taxable year, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be the lower limit for the taxable year.

"(3) UPPER AND LOWER LIMITS.—For purposes of this subsection—

"(A) LOWER LIMIT.—The lower limit for any taxable year is the sum of the amounts applicable under section 213(d) of the Social Security Act for calendar quarters ending with or within such taxable year.

"(B) UPPER LIMIT.—The upper limit for any taxable year is the amount equal to 150 percent of the lower limit for such taxable year.

"(4) DETERMINATION OF GROSS INCOME.—For purposes of this subsection, the term 'gross income' means—

"(A) in the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of subsection (a), and

"(B) in the case of any such trade or business in which the income is computed under an accrual method, the gross income from such trade or business, adjusted in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of subsection (a).

"(5) INCOME DERIVED FROM MORE THAN 1 TRADE OR BUSINESS.—For purposes of this subsection, if an individual (including a member of a partnership) derives gross income from more than 1 such trade or business, such gross income (including his distributive share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business.

"(6) ELECTION.—The option under this subsection shall be allowed for any taxable year only if elected on the first return filed for such taxable year."

(2) CONFORMING AMENDMENT.—Subsection (a) of section 1402 is amended by striking all that follows the first sentence fol-

lowing paragraph (15) and inserting "For optional method of determining net earnings from self-employment, see subsection (h)."

(b) SOCIAL SECURITY ACT.—Subsection (g) of section 211 of the Social Security Act is amended to read as follows:

"(g) OPTIONAL METHOD FOR COMPUTING SELF-EMPLOYMENT INCOME.—

"(1) INDIVIDUALS.—In the case of any trade or business which is carried on by an individual—

"(A) if the gross income derived by him from such trade or business is not more than the upper limit for the taxable year, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be 66⅔ percent of such gross income, or

"(B) if the gross income derived by him from such trade or business is more than the upper limit for the taxable year and the net earnings from self-employment derived by him from such trade or business (computed under subsection (a) without regard to this sentence) are less than the lower limit for the taxable year, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be the lower limit for the taxable year.

"(2) MEMBER OF A PARTNERSHIP.—In the case of a member of a partnership carrying on any trade or business—

"(A) if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) of the Internal Revenue Code of 1986 applies) is not more than the upper limit for the taxable year, his distributive share of income described in section 702(a)(8) of such Code derived from such trade or business may, at his option, be deemed to be an amount equal to 66⅔ percent of his distributive share of such gross income (after such gross income has been so reduced), or

"(B) if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) of such Code applies) is more than the upper limit for the taxable year and his distributive share (whether or not distributed) of income described in section 702(a)(8) of such Code derived from such trade or business (computed under this subsection without regard to this sentence) is less than the lower limit for the taxable year, his distributive share of income described in section 702(a)(8) of such Code derived from such trade or business may, at his option, be deemed to be the lower limit for the taxable year.

"(3) UPPER AND LOWER LIMITS.—For purposes of this subsection—

"(A) LOWER LIMIT.—The lower limit for any taxable year is the sum of the amounts applicable under section 213(d) for calendar quarters ending with or within such taxable year.

"(B) UPPER LIMIT.—The upper limit for any taxable year is the amount equal to 150 percent of the lower limit for such taxable year.

"(4) DETERMINATION OF GROSS INCOME.—For purposes of this subsection, the term 'gross income' means—

"(A) in the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraphs (1) through (6) and paragraph (8) of subsection (a), and

"(B) in the case of any such trade or business in which the income is computed under an accrual method, the gross income from such trade or business, adjusted in accordance with the provisions of paragraphs (1) through (6) and paragraph (8) of subsection (a).

"(5) INCOME DERIVED FROM MORE THAN 1 TRADE OR BUSINESS.—For purposes of this subsection, if an individual (including a member of a partnership) derives gross income from more than 1 such trade or business, such gross income (including his distributive share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business.

"(6) ELECTION.—The option under this subsection shall be allowed for any taxable year only if elected on the first return filed for such taxable year."

(2) CONFORMING AMENDMENT.—Subsection (a) of section 211 of the Social Security Act is amended by striking all that follows the first sentence following paragraph (15) and inserting "For optional method of determining net earnings from self-employment, see subsection (g)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1204. TREATMENT OF CERTAIN REIMBURSED EXPENSES OF RURAL MAIL CARRIERS.

(a) IN GENERAL.—Section 162 (relating to trade or business expenses) is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

"(o) TREATMENT OF CERTAIN REIMBURSED EXPENSES OF RURAL MAIL CARRIERS.—

"(1) GENERAL RULE.—In the case of any employee of the United States Postal Service who performs services involving the collection and delivery of mail on a rural route and who receives qualified reimbursements for the expenses incurred by such employee for the use of a vehicle in performing such services—

"(A) the amount allowable as a deduction under this chapter for the use of a vehicle in performing such services shall be equal to the amount of such qualified reimbursements; and

"(B) such qualified reimbursements shall be treated as paid under a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) (and section 62(c) shall not apply to such qualified reimbursements).

"(2) DEFINITION OF QUALIFIED REIMBURSEMENTS.—For purposes of this subsection, the term 'qualified reimbursements' means the amounts paid by the United States Postal Service to employees as an equipment maintenance allowance under the 1991 collective bargaining agreement between the United States Postal Service and the National Rural Letter Carriers' Association. Amounts paid as an equipment maintenance allowance by such Postal Service under later collective bargaining agreements that supersede the 1991 agreement shall be considered qualified reimbursements if such amounts do not exceed the amounts that would have been paid under the 1991 agreement, adjusted for changes in the Consumer Price Index (as defined in section 1(f)(5)) since 1991."

(b) TECHNICAL AMENDMENT.—Section 6008 of the Technical and Miscellaneous Revenue Act of 1988 is hereby repealed.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1997.

SEC. 1205. TREATMENT OF TRAVELING EXPENSES OF CERTAIN FEDERAL EMPLOYEES ENGAGED IN CRIMINAL INVESTIGATIONS.

(a) IN GENERAL.—Subsection (a) of section 162 is amended by adding at the end the following new sentence: "The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate, or provide support services for the investigation of, a Federal crime."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to amounts paid or incurred with respect to taxable years ending after the date of the enactment of this Act.

SEC. 1206. PAYMENT OF TAX BY COMMERCIALLY ACCEPTABLE MEANS.

(a) GENERAL RULE.—Section 6311 is amended to read as follows:

"SEC. 6311. PAYMENT OF TAX BY COMMERCIALLY ACCEPTABLE MEANS.

"(a) AUTHORITY TO RECEIVE.—It shall be lawful for the Secretary to receive for internal revenue taxes (or in payment for internal revenue stamps) any commercially acceptable means that the Secretary deems appropriate to the extent and under the conditions provided in regulations prescribed by the Secretary.

"(b) ULTIMATE LIABILITY.—If a check, money order, or other method of payment, including payment by credit card, debit card, or charge card so received is not duly paid, or is paid and subsequently charged back to the Secretary, the person by whom such check, or money order, or other method of payment has been tendered shall remain liable for the payment of the tax or for the stamps, and for all legal penalties and additions, to the same extent as if such check, money order, or other method of payment had not been tendered.

"(c) LIABILITY OF BANKS AND OTHERS.—If any certified, treasurer's, or cashier's check (or other guaranteed draft), or any money order, or any other means of payment that has been guaranteed by a financial institution (such as a credit card, debit card, or charge card transaction which has been guaranteed expressly by a financial institution) so received is not duly paid, the United States shall, in addition to its right to exact payment from the party originally indebted therefor, have a lien for—

"(1) the amount of such check (or draft) upon all assets of the financial institution on which drawn,

"(2) the amount of such money order upon all the assets of the issuer thereof, or

"(3) the guaranteed amount of any other transaction upon all the assets of the institution making such guarantee,

and such amount shall be paid out of such assets in preference to any other claims whatsoever against such financial institution, issuer, or guaranteeing institution, except the necessary costs and expenses of administration and the reimbursement of the United States for the amount expended in the redemption of the circulating notes of such financial institution.

"(d) PAYMENT BY OTHER MEANS.—

"(1) AUTHORITY TO PRESCRIBE REGULATIONS.—The Secretary shall prescribe such regulations as the Secretary deems necessary to receive payment by commercially acceptable means, including regulations that—

"(A) specify which methods of payment by commercially acceptable means will be acceptable,

"(B) specify when payment by such means will be considered received,

"(C) identify types of nontax matters related to payment by such means that are to be resolved by persons ultimately liable for payment and financial intermediaries, without the involvement of the Secretary, and

"(D) ensure that tax matters will be resolved by the Secretary, without the involvement of financial intermediaries.

"(2) AUTHORITY TO ENTER INTO CONTRACTS.—Notwithstanding section 3718(f) of title 31, United States Code, the Secretary is authorized to enter into contracts to obtain services related to receiving payment by other means where cost beneficial to the Government.

"(3) SPECIAL PROVISIONS FOR USE OF CREDIT CARDS.—If use of credit cards is accepted as a method of payment of taxes pursuant to subsection (a)—

"(A) a payment of internal revenue taxes (or a payment for internal revenue stamps) by a person by use of a credit card shall not be subject to section 161 of the Truth-in-Lending Act (15 U.S.C. 1666), or to any similar provisions of State law, if the error alleged by the person is an error relating to the underlying tax liability, rather than an error relating to the credit card account such as a computational error or numerical transposition in the credit card transaction or an issue as to whether the person authorized payment by use of the credit card,

"(B) a payment of internal revenue taxes (or a payment for internal revenue stamps) shall not be subject to section 170 of the Truth-in-Lending Act (15 U.S.C. 1666i), or to any similar provisions of State law,

"(C) a payment of internal revenue taxes (or a payment for internal revenue stamps) by a person by use of a debit card shall not be subject to section 908 of the Electronic Fund Transfer Act (15 U.S.C. 1693f), or to any similar provisions of State law, if the error alleged by the person is an error relating to the underlying tax liability, rather than an error relating to the debit card account such as a computational error or numerical transposition in the debit card transaction or an issue as to whether the person authorized payment by use of the debit card,

"(D) the term 'creditor' under section 103(f) of the Truth-in-Lending Act (15 U.S.C. 1602(f)) shall not include the Secretary with respect to credit card transactions in payment of internal revenue taxes (or payment for internal revenue stamps), and

"(E) notwithstanding any other provision of law to the contrary, in the case of payment made by credit card or debit card transaction of an amount owed to a person as the result of the correction of an error under section 161 of the Truth-in-Lending Act (15 U.S.C. 1666) or section 908 of the Electronic Fund Transfer Act (15 U.S.C. 1693f), the Secretary is authorized to provide such amount to such person as a credit to that person's credit card or debit card account through the applicable credit card or debit card system.

"(e) CONFIDENTIALITY OF INFORMATION.—

"(1) IN GENERAL.—Except as otherwise authorized by this subsection, no person may use or disclose any information relating to credit or debit card transactions obtained pursuant to section 6103(k)(8) other than for purposes directly related to the processing of such transactions, or the billing or collection of amounts charged or debited pursuant thereto.

"(2) EXCEPTIONS.—

"(A) Debit or credit card issuers or others acting on behalf of such issuers may also use and disclose such information for purposes directly related to servicing an issuer's accounts.

"(B) Debit or credit card issuers or others directly involved in the processing of credit or debit card transactions or the billing or collection of amounts charged or debited thereto may also use and disclose such information for purposes directly related to—

"(i) statistical risk and profitability assessment;

"(ii) transferring receivables, accounts, or interest therein;

"(iii) auditing the account information;

"(iv) complying with Federal, State, or local law; and "(v) properly authorized civil, criminal, or regulatory investigation by Federal, State, or local authorities.

"(3) PROCEDURES.—Use and disclosure of information under this paragraph shall be made only to the extent authorized by written procedures promulgated by the Secretary.

"(4) CROSS REFERENCE.—

"For provision providing for civil damages for violation of paragraph (1), see section 7431."

(b) SEPARATE APPROPRIATION REQUIRED FOR PAYMENT OF CREDIT CARD FEES.—No amount may be paid by the United States to a credit card issuer for the right to receive payments of internal revenue taxes by credit card without a separate appropriation therefor.

(c) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 64 is amended by striking the item relating to section 6311 and inserting the following:

"Sec. 6311. Payment of tax by commercially acceptable means."

(d) AMENDMENTS TO SECTIONS 6103 AND 7431 WITH RESPECT TO DISCLOSURE AUTHORIZATION.—

(1) Subsection (k) of section 6103 (relating to confidentiality and disclosure of returns and return information) is amended by adding at the end the following new paragraph:

"(8) DISCLOSURE OF INFORMATION TO ADMINISTER SECTION 6311.—The Secretary may disclose returns or return information to financial institutions and others to the extent the Secretary deems necessary for the administration of section 6311. Disclosures of information for purposes other than to accept payments by checks or money orders shall be made only to the extent authorized by written procedures promulgated by the Secretary."

(2) Section 7431 (relating to civil damages for unauthorized disclosure of returns and return information) is amended by adding at the end the following new subsection:

"(g) SPECIAL RULE FOR INFORMATION OBTAINED UNDER SECTION 6103(k)(8).—For purposes of this section, any reference to section 6103 shall be treated as including a reference to section 6311(e)."

(3) Section 6103(p)(3)(A) is amended by striking "or (6)" and inserting "(6), or (8)".

(e) EFFECTIVE DATE.—The amendments made by this section shall take effect on the day 9 months after the date of the enactment of this Act.

Subtitle B—Provisions Relating to Businesses Generally

SEC. 1211. MODIFICATIONS TO LOOK-BACK METHOD FOR LONG-TERM CONTRACTS.

(a) LOOK-BACK METHOD NOT TO APPLY IN CERTAIN CASES.—Subsection (b) of section 460 (relating to percentage of completion method) is amended by adding at the end the following new paragraph:

"(6) ELECTION TO HAVE LOOK-BACK METHOD NOT APPLY IN DE MINIMIS CASES.—

"(A) AMOUNTS TAKEN INTO ACCOUNT AFTER COMPLETION OF CONTRACT.—Paragraph (1)(B) shall not apply with respect to any taxable year (beginning after the taxable year in which the contract is completed) if—

"(i) the cumulative taxable income (or loss) under the contract as of the close of such taxable year, is within

"(ii) 10 percent of the cumulative look-back taxable income (or loss) under the contract as of the close of the most recent taxable year to which paragraph (1)(B) applied (or would have applied but for subparagraph (B)).

"(B) DE MINIMIS DISCREPANCIES.—Paragraph (1)(B) shall not apply in any case to which it would otherwise apply if—

"(i) the cumulative taxable income (or loss) under the contract as of the close of each prior contract year, is within

"(ii) 10 percent of the cumulative look-back income (or loss) under the contract as of the close of such prior contract year.

"(C) DEFINITIONS.—For purposes of this paragraph—

"(i) CONTRACT YEAR.—The term 'contract year' means any taxable year for which income is taken into account under the contract.

"(ii) LOOK-BACK INCOME OR LOSS.—The look-back income (or loss) is the amount which would be the taxable income (or loss) under the contract if the allocation method set forth in paragraph (2)(A) were used in determining taxable income.

"(iii) DISCOUNTING NOT APPLICABLE.—The amounts taken into account after the completion of the contract shall be determined without regard to any discounting under the 2nd sentence of paragraph (2).

"(D) CONTRACTS TO WHICH PARAGRAPH APPLIES.—This paragraph shall only apply if the taxpayer makes an election under this subparagraph. Unless revoked with the consent of the Secretary, such an election shall apply to all long-term contracts completed during the taxable year for which election is made or during any subsequent taxable year."

(b) MODIFICATION OF INTEREST RATE.—

(1) IN GENERAL.—Subparagraph (C) of section 460(b)(2) is amended by striking "the overpayment rate established by section 6621" and inserting "the adjusted overpayment rate (as defined in paragraph (7))".

(2) ADJUSTED OVERPAYMENT RATE.—Subsection (b) of section 460 is amended by adding at the end the following new paragraph:

"(7) ADJUSTED OVERPAYMENT RATE.—

"(A) IN GENERAL.—The adjusted overpayment rate for any interest accrual period is the overpayment rate in effect under section 6621 for the calendar quarter in which such interest accrual period begins.

"(B) INTEREST ACCRUAL PERIOD.—For purposes of subparagraph (A), the term 'interest accrual period' means the period—

"(i) beginning on the day after the return due date for any taxable year of the taxpayer, and

"(ii) ending on the return due date for the following taxable year.

For purposes of the preceding sentence, the term 'return due date' means the date prescribed for filing the return of the tax imposed by this chapter (determined without regard to extensions)."

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contracts completed in taxable years ending after the date of the enactment of this Act.

(2) SUBSECTION (b).—The amendments made by subsection (b) shall apply for purposes of section 167(g) of the Internal Revenue Code of 1986 to property placed in service after September 13, 1995.

SEC. 1212. MINIMUM TAX TREATMENT OF CERTAIN PROPERTY AND CASUALTY INSURANCE COMPANIES.

(a) IN GENERAL.—Clause (i) of section 56(g)(4)(B) (relating to inclusion of items included for purposes of computing earnings and profits) is amended by adding at the end the following new sentence: "In the case of any insurance company taxable under section 831(b), this clause shall not apply to any amount not described in section 834(b)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1997.

Subtitle C—Simplification Relating to Electing Large Partnerships

PART I—GENERAL PROVISIONS

SEC. 1221. SIMPLIFIED FLOW-THROUGH FOR ELECTING LARGE PARTNERSHIPS.

(a) GENERAL RULE.—Subchapter K (relating to partners and partnerships) is amended by adding at the end the following new part:

"PART IV—SPECIAL RULES FOR ELECTING LARGE PARTNERSHIPS

"Sec. 771. Application of subchapter to electing large partnerships.
"Sec. 772. Simplified flow-through.
"Sec. 773. Computations at partnership level.
"Sec. 774. Other modifications.
"Sec. 775. Electing large partnership defined.
"Sec. 776. Special rules for partnerships holding oil and gas properties.
"Sec. 777. Regulations.

"SEC. 771. APPLICATION OF SUBCHAPTER TO ELECTING LARGE PARTNERSHIPS.

"The preceding provisions of this subchapter to the extent inconsistent with the provisions of this part shall not apply to an electing large partnership and its partners.

"SEC. 772. SIMPLIFIED FLOW-THROUGH.

"(a) GENERAL RULE.—In determining the income tax of a partner of an electing large partnership, such partner shall take into account separately such partner's distributive share of the partnership's—

"(1) taxable income or loss from passive loss limitation activities,

"(2) taxable income or loss from other activities,

"(3) net capital gain (or net capital loss)—

"(A) to the extent allocable to passive loss limitation activities, and

"(B) to the extent allocable to other activities,

"(4) tax-exempt interest,

"(5) applicable net AMT adjustment separately computed for—

"(A) passive loss limitation activities, and

"(B) other activities,

"(6) general credits,

"(7) low-income housing credit determined under section 42,

"(8) rehabilitation credit determined under section 47,

"(9) foreign income taxes,

"(10) the credit allowable under section 29, and

"(11) other items to the extent that the Secretary determines that the separate treatment of such items is appropriate.

"(b) SEPARATE COMPUTATIONS.—In determining the amounts required under subsection (a) to be separately taken into account by any partner, this section and section 773 shall be applied separately with respect to such partner by taking into account such partner's distributive share of the items of income, gain, loss, deduction, or credit of the partnership.

"(c) TREATMENT AT PARTNER LEVEL.—

"(1) IN GENERAL.—Except as provided in this subsection, rules similar to the rules of section 702(b) shall apply to any partner's distributive share of the amounts referred to in subsection (a).

"(2) INCOME OR LOSS FROM PASSIVE LOSS LIMITATION ACTIVITIES.—For purposes of this chapter, any partner's distributive share of any income or loss described in subsection (a)(1) shall be treated as an item of income or loss (as the case may be) from the conduct of a trade or business which is a single passive activity (as defined in section 469). A similar rule shall apply to a partner's distributive share of amounts referred to in paragraphs (3)(A) and (5)(A) of subsection (a).

"(3) INCOME OR LOSS FROM OTHER ACTIVITIES.—

"(A) IN GENERAL.—For purposes of this chapter, any partner's distributive share of any income or loss described in subsection (a)(2) shall be treated as an item of income or expense (as the case may be) with respect to property held for investment.

"(B) DEDUCTIONS FOR LOSS NOT SUBJECT TO SECTION 67.—The deduction under section 212 for any loss described in subparagraph (A) shall not be treated as a miscellaneous itemized deduction for purposes of section 67.

"(4) TREATMENT OF NET CAPITAL GAIN OR LOSS.—For purposes of this chapter, any partner's distributive share of any gain or loss described in subsection (a)(3) shall be treated as a long-term capital gain or loss, as the case may be.

"(5) MINIMUM TAX TREATMENT.—In determining the alternative minimum taxable income of any partner, such partner's distributive share of any applicable net AMT adjustment shall be taken into account in lieu of making the separate adjustments provided in sections 56, 57, and 58 with respect to the items of the partnership. Except as provided in regulations, the applicable net AMT adjustment shall be treated, for purposes of section 53, as an adjustment or item of tax preference not specified in section 53(d)(1)(B)(ii).

"(6) GENERAL CREDITS.—A partner's distributive share of the amount referred to in paragraph (6) of subsection (a) shall be taken into account as a current year business credit.

"(d) OPERATING RULES.—For purposes of this section—

"(1) PASSIVE LOSS LIMITATION ACTIVITY.—The term 'passive loss limitation activity' means—

"(A) any activity which involves the conduct of a trade or business, and

"(B) any rental activity.

For purposes of the preceding sentence, the term 'trade or business' includes any activity treated as a trade or business under paragraph (5) or (6) of section 469(c).

"(2) TAX-EXEMPT INTEREST.—The term 'tax-exempt interest' means interest excludable from gross income under section 103.

"(3) APPLICABLE NET AMT ADJUSTMENT.—

"(A) IN GENERAL.—The applicable net AMT adjustment is—

"(i) with respect to taxpayers other than corporations, the net adjustment determined by using the adjustments applicable to individuals, and

"(ii) with respect to corporations, the net adjustment determined by using the adjustments applicable to corporations.

"(B) NET ADJUSTMENT.—The term 'net adjustment' means the net adjustment in the items attributable to passive loss activities or other activities (as the case may be) which would result if such items were determined with the adjustments of sections 56, 57, and 58.

"(4) TREATMENT OF CERTAIN SEPARATELY STATED ITEMS.—

"(A) EXCLUSION FOR CERTAIN PURPOSES.—In determining the amounts referred to in paragraphs (1) and (2) of subsection (a), any net capital gain or net capital loss (as the case may be), and any item referred to in subsection (a)(11), shall be excluded.

"(B) ALLOCATION RULES.—The net capital gain shall be treated—

"(i) as allocable to passive loss limitation activities to the extent the net capital gain does not exceed the net capital gain determined by only taking into account gains and losses from sales and exchanges of property used in connection with such activities, and

"(ii) as allocable to other activities to the extent such gain exceeds the amount allocated under clause (i).

A similar rule shall apply for purposes of allocating any net capital loss.

"(C) NET CAPITAL LOSS.—The term 'net capital loss' means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchange of capital assets.

"(5) GENERAL CREDITS.—The term 'general credits' means any credit other than the low-income housing credit, the rehabilitation credit, the foreign tax credit, and the credit allowable under section 29.

"(6) FOREIGN INCOME TAXES.—The term 'foreign income taxes' means taxes described in section 901 which are paid or accrued to foreign countries and to possessions of the United States.

"(e) SPECIAL RULE FOR UNRELATED BUSINESS TAX.—In the case of a partner which is an organization subject to tax under section 511, such partner's distributive share of any items shall be taken into account separately to the extent necessary to comply with the provisions of section 512(c)(1).

"(f) SPECIAL RULES FOR APPLYING PASSIVE LOSS LIMITATIONS.—If any person holds an interest in an electing large partnership other than as a limited partner—

"(1) paragraph (2) of subsection (c) shall not apply to such partner, and

"(2) such partner's distributive share of the partnership items allocable to passive loss limitation activities shall be taken into account separately to the extent necessary to comply with the provisions of section 469.

The preceding sentence shall not apply to any items allocable to an interest held as a limited partner.

"SEC. 773. COMPUTATIONS AT PARTNERSHIP LEVEL.

"(a) GENERAL RULE.—

"(1) TAXABLE INCOME.—The taxable income of an electing large partnership shall be computed in the same manner as in the case of an individual except that—

"(A) the items described in section 772(a) shall be separately stated, and

"(B) the modifications of subsection (b) shall apply.

"(2) ELECTIONS.—All elections affecting the computation of the taxable income of an electing large partnership or the computation of any credit of an electing large partnership shall be made by the partnership; except that the election under section 901, and any election under section 108, shall be made by each partner separately.

"(3) LIMITATIONS, ETC.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), all limitations and other provisions affecting the computation of the taxable income of an electing large partnership or the computation of any credit of an electing large partnership shall be applied at the partnership level (and not at the partner level).

"(B) CERTAIN LIMITATIONS APPLIED AT PARTNER LEVEL.—The following provisions shall be applied at the partner level (and not at the partnership level):

"(i) Section 68 (relating to overall limitation on itemized deductions).

"(ii) Sections 49 and 465 (relating to at risk limitations).

"(iii) Section 469 (relating to limitation on passive activity losses and credits).

"(iv) Any other provision specified in regulations.

"(4) COORDINATION WITH OTHER PROVISIONS.—Paragraphs (2) and (3) shall apply notwithstanding any other provision of this chapter other than this part.

"(b) MODIFICATIONS TO DETERMINATION OF TAXABLE INCOME.—In determining the taxable income of an electing large partnership—

"(1) CERTAIN DEDUCTIONS NOT ALLOWED.—The following deductions shall not be allowed:

"(A) The deduction for personal exemptions provided in section 151.

"(B) The net operating loss deduction provided in section 172.

"(C) The additional itemized deductions for individuals provided in part VII of subchapter B (other than section 212 thereof).

"(2) CHARITABLE DEDUCTIONS.—In determining the amount allowable under section 170, the limitation of section 170(b)(2) shall apply.

"(3) COORDINATION WITH SECTION 67.—In lieu of applying section 67, 70 percent of the amount of the miscellaneous itemized deductions shall be disallowed.

"(c) SPECIAL RULES FOR INCOME FROM DISCHARGE OF INDEBTEDNESS.—If an electing large partnership has income from the discharge of any indebtedness—

"(1) such income shall be excluded in determining the amounts referred to in section 772(a), and

"(2) in determining the income tax of any partner of such partnership—

"(A) such income shall be treated as an item required to be separately taken into account under section 772(a), and

"(B) the provisions of section 108 shall be applied without regard to this part.

"SEC. 774. OTHER MODIFICATIONS.

"(a) TREATMENT OF CERTAIN OPTIONAL ADJUSTMENTS, ETC.—In the case of an electing large partnership—

"(1) computations under section 773 shall be made without regard to any adjustment under section 743(b) or 108(b), but

"(2) a partner's distributive share of any amount referred to in section 772(a) shall be appropriately adjusted to take into account any adjustment under section 743(b) or 108(b) with respect to such partner.

“(b) CREDIT RECAPTURE DETERMINED AT PARTNERSHIP LEVEL.—

“(1) IN GENERAL.—In the case of an electing large partnership—

“(A) any credit recapture shall be taken into account by the partnership, and

“(B) the amount of such recapture shall be determined as if the credit with respect to which the recapture is made had been fully utilized to reduce tax.

“(2) METHOD OF TAKING RECAPTURE INTO ACCOUNT.—An electing large partnership shall take into account a credit recapture by reducing the amount of the appropriate current year credit to the extent thereof, and if such recapture exceeds the amount of such current year credit, the partnership shall be liable to pay such excess.

“(3) DISPOSITIONS NOT TO TRIGGER RECAPTURE.—No credit recapture shall be required by reason of any transfer of an interest in an electing large partnership.

“(4) CREDIT RECAPTURE.—For purposes of this subsection, the term ‘credit recapture’ means any increase in tax under section 42(j) or 50(a).

“(c) PARTNERSHIP NOT TERMINATED BY REASON OF CHANGE IN OWNERSHIP.—Subparagraph (B) of section 708(b)(1) shall not apply to an electing large partnership.

“(d) PARTNERSHIP ENTITLED TO CERTAIN CREDITS.—The following shall be allowed to an electing large partnership and shall not be taken into account by the partners of such partnership:

“(1) The credit provided by section 34.

“(2) Any credit or refund under section 852(b)(3)(D).

“(e) TREATMENT OF REMIC RESIDUALS.—For purposes of applying section 860E(e)(6) to any electing large partnership—

“(1) all interests in such partnership shall be treated as held by disqualified organizations,

“(2) in lieu of applying subparagraph (C) of section 860E(e)(6), the amount subject to tax under section 860E(e)(6) shall be excluded from the gross income of such partnership, and

“(3) subparagraph (D) of section 860E(e)(6) shall not apply.

“(f) SPECIAL RULES FOR APPLYING CERTAIN INSTALLMENT SALE RULES.—In the case of an electing large partnership—

“(1) the provisions of sections 453(l)(3) and 453A shall be applied at the partnership level, and

“(2) in determining the amount of interest payable under such sections, such partnership shall be treated as subject to tax under this chapter at the highest rate of tax in effect under section 1 or 11.

“SEC. 775. ELECTING LARGE PARTNERSHIP DEFINED.

“(a) GENERAL RULE.—For purposes of this part—

“(1) IN GENERAL.—The term ‘electing large partnership’ means, with respect to any partnership taxable year, any partnership if—

“(A) the number of persons who were partners in such partnership in the preceding partnership taxable year equaled or exceeded 100, and

“(B) such partnership elects the application of this part.

To the extent provided in regulations, a partnership shall cease to be treated as an electing large partnership for any partnership taxable year if in such taxable year fewer than 100 persons were partners in such partnership.

"(2) ELECTION.—The election under this subsection shall apply to the taxable year for which made and all subsequent taxable years unless revoked with the consent of the Secretary.

"(b) SPECIAL RULES FOR CERTAIN SERVICE PARTNERSHIPS.—

"(1) CERTAIN PARTNERS NOT COUNTED.—For purposes of this section, the term 'partner' does not include any individual performing substantial services in connection with the activities of the partnership and holding an interest in such partnership, or an individual who formerly performed substantial services in connection with such activities and who held an interest in such partnership at the time the individual performed such services.

"(2) EXCLUSION.—For purposes of this part, an election under subsection (a) shall not be effective with respect to any partnership if substantially all the partners of such partnership—

"(A) are individuals performing substantial services in connection with the activities of such partnership or are personal service corporations (as defined in section 269A(b)) the owner-employees (as defined in section 269A(b)) of which perform such substantial services,

"(B) are retired partners who had performed such substantial services, or

"(C) are spouses of partners who are performing (or had previously performed) such substantial services.

"(3) SPECIAL RULE FOR LOWER TIER PARTNERSHIPS.—For purposes of this subsection, the activities of a partnership shall include the activities of any other partnership in which the partnership owns directly an interest in the capital and profits of at least 80 percent.

"(c) EXCLUSION OF COMMODITY POOLS.—For purposes of this part, an election under subsection (a) shall not be effective with respect to any partnership the principal activity of which is the buying and selling of commodities (not described in section 1221(1)), or options, futures, or forwards with respect to such commodities.

"(d) SECRETARY MAY RELY ON TREATMENT ON RETURN.—If, on the partnership return of any partnership, such partnership is treated as an electing large partnership, such treatment shall be binding on such partnership and all partners of such partnership but not on the Secretary.

"SEC. 776. SPECIAL RULES FOR PARTNERSHIPS HOLDING OIL AND GAS PROPERTIES.

"(a) COMPUTATION OF PERCENTAGE DEPLETION.—In the case of an electing large partnership, except as provided in subsection (b)—

"(1) the allowance for depletion under section 611 with respect to any partnership oil or gas property shall be computed at the partnership level without regard to any provision of section 613A requiring such allowance to be computed separately by each partner, "(2) such allowance shall be determined without regard to the provisions of section 613A(c) limiting the amount of production for which percentage depletion is allowable and without regard to paragraph (1) of section 613A(d), and

"(3) paragraph (3) of section 705(a) shall not apply.

"(b) TREATMENT OF CERTAIN PARTNERS.—

"(1) IN GENERAL.—In the case of a disqualified person, the treatment under this chapter of such person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property shall be determined without regard to this part. Such person's distributive share of any such items shall be excluded for purposes of making determinations under sections 772 and 773.

"(2) DISQUALIFIED PERSON.—For purposes of paragraph (1), the term 'disqualified person' means, with respect to any partnership taxable year—

"(A) any person referred to in paragraph (2) or (4) of section 613A(d) for such person's taxable year in which such partnership taxable year ends, and

"(B) any other person if such person's average daily production of domestic crude oil and natural gas for such person's taxable year in which such partnership taxable year ends exceeds 500 barrels.

"(3) AVERAGE DAILY PRODUCTION.—For purposes of paragraph (2), a person's average daily production of domestic crude oil and natural gas for any taxable year shall be computed as provided in section 613A(c)(2)—

"(A) by taking into account all production of domestic crude oil and natural gas (including such person's proportionate share of any production of a partnership),

"(B) by treating 6,000 cubic feet of natural gas as a barrel of crude oil, and

"(C) by treating as 1 person all persons treated as 1 taxpayer under section 613A(c)(8) or among whom allocations are required under such section.

"SEC. 777. REGULATIONS.

"The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this part."

(b) CLERICAL AMENDMENT.—The table of parts for subchapter K of chapter 1 is amended by adding at the end the following new item:

"Part IV. Special rules for electing large partnerships."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years beginning after December 31, 1997.

SEC. 1222. SIMPLIFIED AUDIT PROCEDURES FOR ELECTING LARGE PARTNERSHIPS.

(a) GENERAL RULE.—Chapter 63 is amended by adding at the end thereof the following new subchapter:

"Subchapter D—Treatment of electing large partnerships

"Part I. Treatment of partnership items and adjustments.

“Part II. Partnership level adjustments.
“Part III. Definitions and special rules.

“PART I—TREATMENT OF PARTNERSHIP ITEMS AND ADJUSTMENTS

“Sec. 6240. Application of subchapter.
“Sec. 6241. Partner’s return must be consistent with partnership return.
“Sec. 6242. Procedures for taking partnership adjustments into account.

“SEC. 6240. APPLICATION OF SUBCHAPTER.

“(a) GENERAL RULE.—This subchapter shall only apply to electing large partnerships and partners in such partnerships.

“(b) COORDINATION WITH OTHER PARTNERSHIP AUDIT PROCEDURES.—

“(1) IN GENERAL.—Subchapter C of this chapter shall not apply to any electing large partnership other than in its capacity as a partner in another partnership which is not an electing large partnership.

“(2) TREATMENT WHERE PARTNER IN OTHER PARTNERSHIP.—If an electing large partnership is a partner in another partnership which is not an electing large partnership—

“(A) subchapter C of this chapter shall apply to items of such electing large partnership which are partnership items with respect to such other partnership, but

“(B) any adjustment under such subchapter C shall be taken into account in the manner provided by section 6242.

“SEC. 6241. PARTNER’S RETURN MUST BE CONSISTENT WITH PARTNERSHIP RETURN.

“(a) GENERAL RULE.—A partner of any electing large partnership shall, on the partner’s return, treat each partnership item attributable to such partnership in a manner which is consistent with the treatment of such partnership item on the partnership return.

“(b) UNDERPAYMENT DUE TO INCONSISTENT TREATMENT ASSESSED AS MATH ERROR.—Any underpayment of tax by a partner by reason of failing to comply with the requirements of subsection (a) shall be assessed and collected in the same manner as if such underpayment were on account of a mathematical or clerical error appearing on the partner’s return. Paragraph (2) of section 6213(b) shall not apply to any assessment of an underpayment referred to in the preceding sentence.

“(c) ADJUSTMENTS NOT TO AFFECT PRIOR YEAR OF PARTNERS.—

“(1) IN GENERAL.—Except as provided in paragraph (2), subsections (a) and (b) shall apply without regard to any adjustment to the partnership item under part II.

“(2) CERTAIN CHANGES IN DISTRIBUTIVE SHARE TAKEN INTO ACCOUNT BY PARTNER.—

“(A) IN GENERAL.—To the extent that any adjustment under part II involves a change under section 704 in a partner’s distributive share of the amount of any partnership item shown on the partnership return, such adjustment shall be taken into account in applying this title to such partner for the partner's taxable year for which such item was required to be taken into account.

"(B) COORDINATION WITH DEFICIENCY PROCEDURES.—

"(i) IN GENERAL.—Subchapter B shall not apply to the assessment or collection of any underpayment of tax attributable to an adjustment referred to in subparagraph (A).

"(ii) ADJUSTMENT NOT PRECLUDED.—Notwithstanding any other law or rule of law, nothing in subchapter B (or in any proceeding under subchapter B) shall preclude the assessment or collection of any underpayment of tax (or the allowance of any credit or refund of any overpayment of tax) attributable to an adjustment referred to in subparagraph (A) and such assessment or collection or allowance (or any notice thereof) shall not preclude any notice, proceeding, or determination under subchapter B.

"(C) PERIOD OF LIMITATIONS.—The period for—

"(i) assessing any underpayment of tax, or

"(ii) filing a claim for credit or refund of any overpayment of tax,

attributable to an adjustment referred to in subparagraph (A) shall not expire before the close of the period prescribed by section 6248 for making adjustments with respect to the partnership taxable year involved.

"(D) TIERED STRUCTURES.—If the partner referred to in subparagraph (A) is another partnership or an S corporation, the rules of this paragraph shall also apply to persons holding interests in such partnership or S corporation (as the case may be); except that, if such partner is an electing large partnership, the adjustment referred to in subparagraph (A) shall be taken into account in the manner provided by section 6242.

"(d) ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION.—

"For addition to tax in case of partner's disregard of requirements of this section, see part II of subchapter A of chapter 68.

"SEC. 6242. PROCEDURES FOR TAKING PARTNERSHIP ADJUSTMENTS INTO ACCOUNT.

"(a) ADJUSTMENTS FLOW THROUGH TO PARTNERS FOR YEAR IN WHICH ADJUSTMENT TAKES EFFECT.—

"(1) IN GENERAL.—If any partnership adjustment with respect to any partnership item takes effect (within the meaning of subsection (d)(2)) during any partnership taxable year and if an election under paragraph (2) does not apply to such adjustment, such adjustment shall be taken into account in determining the amount of such item for the partnership taxable year in which such adjustment takes effect. In applying this title to any person who is (directly or indirectly) a partner in such partnership during such partnership taxable year, such adjustment shall be treated as an item actually arising during such taxable year.

"(2) PARTNERSHIP LIABLE IN CERTAIN CASES.—If—

"(A) a partnership elects under this paragraph to not take an adjustment into account under paragraph (1), "(B) a partnership does not make such an election but in filing its return for any partnership taxable year fails to take fully into account any partnership adjustment as required under paragraph (1), or

"(C) any partnership adjustment involves a reduction in a credit which exceeds the amount of such credit determined for the partnership taxable year in which the adjustment takes effect,

the partnership shall pay to the Secretary an amount determined by applying the rules of subsection (b)(4) to the adjustments not so taken into account and any excess referred to in subparagraph (C).

"(3) OFFSETTING ADJUSTMENTS TAKEN INTO ACCOUNT.—If a partnership adjustment requires another adjustment in a taxable year after the adjusted year and before the partnership taxable year in which such partnership adjustment takes effect, such other adjustment shall be taken into account under this subsection for the partnership taxable year in which such partnership adjustment takes effect.

"(4) COORDINATION WITH PART II.—Amounts taken into account under this subsection for any partnership taxable year shall continue to be treated as adjustments for the adjusted year for purposes of determining whether such amounts may be readjusted under part II.

"(b) PARTNERSHIP LIABLE FOR INTEREST AND PENALTIES.—

"(1) IN GENERAL.—If a partnership adjustment takes effect during any partnership taxable year and such adjustment results in an imputed underpayment for the adjusted year, the partnership—

"(A) shall pay to the Secretary interest computed under paragraph (2), and

"(B) shall be liable for any penalty, addition to tax, or additional amount as provided in paragraph (3).

"(2) DETERMINATION OF AMOUNT OF INTEREST.—The interest computed under this paragraph with respect to any partnership adjustment is the interest which would be determined under chapter 67—

"(A) on the imputed underpayment determined under paragraph (4) with respect to such adjustment,

"(B) for the period beginning on the day after the return due date for the adjusted year and ending on the return due date for the partnership taxable year in which such adjustment takes effect (or, if earlier, in the case of any adjustment to which subsection (a)(2) applies, the date on which the payment under subsection (a)(2) is made).

Proper adjustments in the amount determined under the preceding sentence shall be made for adjustments required for partnership taxable years after the adjusted year and before the year in which the partnership adjustment takes effect by reason of such partnership adjustment.

"(3) PENALTIES.—A partnership shall be liable for any penalty, addition to tax, or additional amount for which it would have been liable if such partnership had been an individual subject to tax under chapter 1 for the adjusted year and the imputed underpayment determined under paragraph (4) were an actual underpayment (or understatement) for such year.

"(4) IMPUTED UNDERPAYMENT.—For purposes of this subsection, the imputed underpayment determined under this paragraph with respect to any partnership adjustment is the underpayment (if any) which would result—

"(A) by netting all adjustments to items of income, gain, loss, or deduction and by treating any net increase in income as an underpayment equal to the amount of such net increase multiplied by the highest rate of tax in effect under section 1 or 11 for the adjusted year, and

"(B) by taking adjustments to credits into account as increases or decreases (whichever is appropriate) in the amount of tax.

For purposes of the preceding sentence, any net decrease in a loss shall be treated as an increase in income and a similar rule shall apply to a net increase in a loss.

"(c) ADMINISTRATIVE PROVISIONS.—

"(1) IN GENERAL.—Any payment required by subsection (a)(2) or (b)(1)(A)—

"(A) shall be assessed and collected in the same manner as if it were a tax imposed by subtitle C, and

"(B) shall be paid on or before the return due date for the partnership taxable year in which the partnership adjustment takes effect.

"(2) INTEREST.—For purposes of determining interest, any payment required by subsection (a)(2) or (b)(1)(A) shall be treated as an underpayment of tax.

"(3) PENALTIES.—

"(A) IN GENERAL.—In the case of any failure by any partnership to pay on the date prescribed therefor any amount required by subsection (a)(2) or (b)(1)(A), there is hereby imposed on such partnership a penalty of 10 percent of the underpayment. For purposes of the preceding sentence, the term 'underpayment' means the excess of any payment required under this section over the amount (if any) paid on or before the date prescribed therefor.

"(B) ACCURACY-RELATED AND FRAUD PENALTIES MADE APPLICABLE.—For purposes of part II of subchapter A of chapter 68, any payment required by subsection (a)(2) shall be treated as an underpayment of tax.

"(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) PARTNERSHIP ADJUSTMENT.—The term 'partnership adjustment' means any adjustment in the amount of any partnership item of an electing large partnership.

"(2) WHEN ADJUSTMENT TAKES EFFECT.—A partnership adjustment takes effect—

"(A) in the case of an adjustment pursuant to the decision of a court in a proceeding brought under part II, when such decision becomes final,

"(B) in the case of an adjustment pursuant to any administrative adjustment request under section 6251, when such adjustment is allowed by the Secretary, or

"(C) in any other case, when such adjustment is made.

"(3) ADJUSTED YEAR.—The term 'adjusted year' means the partnership taxable year to which the item being adjusted relates.

"(4) RETURN DUE DATE.—The term 'return due date' means, with respect to any taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

"(5) ADJUSTMENTS INVOLVING CHANGES IN CHARACTER.—Under regulations, appropriate adjustments in the application of this section shall be made for purposes of taking into account partnership adjustments which involve a change in the character of any item of income, gain, loss, or deduction.

"(e) PAYMENTS NONDEDUCTIBLE.—No deduction shall be allowed under subtitle A for any payment required to be made by an electing large partnership under this section.

"PART II—PARTNERSHIP LEVEL ADJUSTMENTS

"Subpart A. Adjustments by Secretary.
"Subpart B. Claims for adjustments by partnership.

"Subpart A—Adjustments by Secretary

"Sec. 6245. Secretarial authority.
"Sec. 6246. Restrictions on partnership adjustments.
"Sec. 6247. Judicial review of partnership adjustment.
"Sec. 6248. Period of limitations for making adjustments.

"SEC. 6245. SECRETARIAL AUTHORITY.

"(a) GENERAL RULE.—The Secretary is authorized and directed to make adjustments at the partnership level in any partnership item to the extent necessary to have such item be treated in the manner required.

"(b) NOTICE OF PARTNERSHIP ADJUSTMENT.—

"(1) IN GENERAL.—If the Secretary determines that a partnership adjustment is required, the Secretary is authorized to send notice of such adjustment to the partnership by certified mail or registered mail. Such notice shall be sufficient if mailed to the partnership at its last known address even if the partnership has terminated its existence.

"(2) FURTHER NOTICES RESTRICTED.—If the Secretary mails a notice of a partnership adjustment to any partnership for any partnership taxable year and the partnership files a petition under section 6247 with respect to such notice, in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact, the Secretary shall not mail another such notice to such partnership with respect to such taxable year.

"(3) AUTHORITY TO RESCIND NOTICE WITH PARTNERSHIP CONSENT.—The Secretary may, with the consent of the partnership, rescind any notice of a partnership adjustment mailed to such partnership. Any notice so rescinded shall not be treated as a notice of a partnership adjustment, for purposes of this section, section 6246, and section 6247, and the taxpayer shall have no right to bring a proceeding under section 6247 with respect to such notice. Nothing in this subsection shall affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding.

"SEC. 6246. RESTRICTIONS ON PARTNERSHIP ADJUSTMENTS.

"(a) GENERAL RULE.—Except as otherwise provided in this chapter, no adjustment to any partnership item may be made (and no levy or proceeding in any court for the collection of any amount resulting from such adjustment may be made, begun or prosecuted) before—

"(1) the close of the 90th day after the day on which a notice of a partnership adjustment was mailed to the partnership, and

"(2) if a petition is filed under section 6247 with respect to such notice, the decision of the court has become final.

"(b) PREMATURE ACTION MAY BE ENJOINED.—Notwithstanding section 7421(a), any action which violates subsection (a) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action under this subsection unless a timely petition has been filed under section 6247 and then only in respect of the adjustments that are the subject of such petition.

"(c) EXCEPTIONS TO RESTRICTIONS ON ADJUSTMENTS.—

"(1) ADJUSTMENTS ARISING OUT OF MATH OR CLERICAL ERRORS.—

"(A) IN GENERAL.—If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to a partnership item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.

"(B) SPECIAL RULE.—If an electing large partnership is a partner in another electing large partnership, any adjustment on account of such partnership's failure to comply with the requirements of section 6241(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph (A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment.

"(2) PARTNERSHIP MAY WAIVE RESTRICTIONS.—The partnership shall at any time (whether or not a notice of partnership adjustment has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the making of any partnership adjustment.

"(d) LIMIT WHERE NO PROCEEDING BEGUN.—If no proceeding under section 6247 is begun with respect to any notice of a partnership adjustment during the 90-day period described in subsection (a), the amount for which the partnership is liable under section 6242 (and any increase in any partner's liability for tax under chapter 1 by reason of any adjustment under section 6242(a)) shall not exceed the amount determined in accordance with such notice.

"SEC. 6247. JUDICIAL REVIEW OF PARTNERSHIP ADJUSTMENT.

"(a) GENERAL RULE.—Within 90 days after the date on which a notice of a partnership adjustment is mailed to the partnership with respect to any partnership taxable year, the partnership may file a petition for a readjustment of the partnership items for such taxable year with—

"(1) the Tax Court,

"(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

"(3) the Claims Court.

"(b) JURISDICTIONAL REQUIREMENT FOR BRINGING ACTION IN DISTRICT COURT OR CLAIMS COURT.—

"(1) IN GENERAL.—A readjustment petition under this section may be filed in a district court of the United States or the Claims Court only if the partnership filing the petition deposits with the Secretary, on or before the date the petition is filed, the amount for which the partnership would be liable under section 6242(b) (as of the date of the filing of the petition) if the partnership items were adjusted as provided by the notice of partnership adjustment. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirement and any shortfall of the amount required to be deposited is timely corrected.

"(2) INTEREST PAYABLE.—Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

"(c) SCOPE OF JUDICIAL REVIEW.—A court with which a petition is filed in accordance with this section shall have jurisdiction to determine 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 (and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under section 6242(b)).

"(d) DETERMINATION OF COURT REVIEWABLE.—Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

"(e) EFFECT OF DECISION DISMISSING ACTION.—If an action brought under this section is dismissed other than by reason of a rescission under section 6245(b)(3), the decision of the court dismissing the action shall be considered as its decision that the notice of partnership adjustment is correct, and an appropriate order shall be entered in the records of the court.

"SEC. 6248. PERIOD OF LIMITATIONS FOR MAKING ADJUSTMENTS.

"(a) GENERAL RULE.—Except as otherwise provided in this section, no adjustment under this subpart to any partnership item for any partnership taxable year may be made after the date which is 3 years after the later of—

"(1) the date on which the partnership return for such taxable year was filed, or

"(2) the last day for filing such return for such year (determined without regard to extensions).

"(b) EXTENSION BY AGREEMENT.—The period described in subsection (a) (including an extension period under this subsection) may be extended by an agreement entered into by the Secretary and the partnership before the expiration of such period.

"(c) SPECIAL RULE IN CASE OF FRAUD, ETC.—

"(1) FALSE RETURN.—In the case of a false or fraudulent partnership return with intent to evade tax, the adjustment may be made at any time.

"(2) SUBSTANTIAL OMISSION OF INCOME.—If any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return, subsection (a) shall be applied by substituting '6 years' for '3 years'.

"(3) NO RETURN.—In the case of a failure by a partnership to file a return for any taxable year, the adjustment may be made at any time.

"(4) RETURN FILED BY SECRETARY.—For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

"(d) SUSPENSION WHEN SECRETARY MAILS NOTICE OF ADJUSTMENT.—If notice of a partnership adjustment with respect to any taxable year is mailed to the partnership, the running of the period specified in subsection (a) (as modified by the other provisions of this section) shall be suspended—

"(1) for the period during which an action may be brought under section 6247 (and, if a petition is filed under section 6247 with respect to such notice, until the decision of the court becomes final), and

"(2) for 1 year thereafter.

"Subpart B—Claims for Adjustments by Partnership

"Sec. 6251. Administrative adjustment requests.
"Sec. 6252. Judicial review where administrative adjustment request is not allowed in full.

"SEC. 6251. ADMINISTRATIVE ADJUSTMENT REQUESTS.

"(a) GENERAL RULE.—A partnership may file a request for an administrative adjustment of partnership items for any partnership taxable year at any time which is—

"(1) within 3 years after the later of—

"(A) the date on which the partnership return for such year is filed, or

"(B) the last day for filing the partnership return for such year (determined without regard to extensions), and

"(2) before the mailing to the partnership of a notice of a partnership adjustment with respect to such taxable year.

"(b) SECRETARIAL ACTION.—If a partnership files an administrative adjustment request under subsection (a), the Secretary may allow any part of the requested adjustments.

"(c) SPECIAL RULE IN CASE OF EXTENSION UNDER SECTION 6248.—If the period described in section 6248(a) is extended pursuant to an agreement under section 6248(b), the period prescribed by subsection (a)(1) shall not expire before the date 6 months after the expiration of the extension under section 6248(b).

"SEC. 6252. JUDICIAL REVIEW WHERE ADMINISTRATIVE ADJUSTMENT REQUEST IS NOT ALLOWED IN FULL.

"(a) IN GENERAL.—If any part of an administrative adjustment request filed under section 6251 is not allowed by the Secretary, the partnership may file a petition for an adjustment with respect to the partnership items to which such part of the request relates with—

"(1) the Tax Court,

"(2) the district court of the United States for the district in which the principal place of business of the partnership is located, or

"(3) the Claims Court.

"(b) PERIOD FOR FILING PETITION.—A petition may be filed under subsection (a) with respect to partnership items for a partnership taxable year only—

"(1) after the expiration of 6 months from the date of filing of the request under section 6251, and

"(2) before the date which is 2 years after the date of such request.

The 2-year period set forth in paragraph (2) shall be extended for such period as may be agreed upon in writing by the partnership and the Secretary.

"(c) COORDINATION WITH SUBPART A.—

"(1) NOTICE OF PARTNERSHIP ADJUSTMENT BEFORE FILING OF PETITION.—No petition may be filed under this section after the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year to which the request under section 6251 relates.

"(2) NOTICE OF PARTNERSHIP ADJUSTMENT AFTER FILING BUT BEFORE HEARING OF PETITION.—If the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year to which the request under section 6251 relates after the filing of a petition under this subsection but before the hearing of such petition, such petition shall be treated as an action brought under section 6247 with respect to such notice, except that subsection (b) of section 6247 shall not apply.

"(3) NOTICE MUST BE BEFORE EXPIRATION OF STATUTE OF LIMITATIONS.—A notice of a partnership adjustment for the partnership taxable year shall be taken into account under paragraphs (1) and (2) only if such notice is mailed before the expiration of the period prescribed by section 6248 for making adjustments to partnership items for such taxable year.

"(d) SCOPE OF JUDICIAL REVIEW.—Except in the case described in paragraph (2) of subsection (c), a court with which a petition is filed in accordance with this section shall have jurisdiction to determine only those partnership items to which the part of the request under section 6251 not allowed by the Secretary relates and those items with respect to which the Secretary asserts adjustments as offsets to the adjustments requested by the partnership.

"(e) DETERMINATION OF COURT REVIEWABLE.—Any determination by a court under this subsection shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

"PART III—DEFINITIONS AND SPECIAL RULES

"Sec. 6255. Definitions and special rules.

"SEC. 6255. DEFINITIONS AND SPECIAL RULES.

"(a) DEFINITIONS.—For purposes of this subchapter—

"(1) ELECTING LARGE PARTNERSHIP.—The term 'electing large partnership' has the meaning given to such term by section 775.

"(2) PARTNERSHIP ITEM.—The term 'partnership item' has the meaning given to such term by section 6231(a)(3).

"(b) PARTNERS BOUND BY ACTIONS OF PARTNERSHIP, ETC.—

"(1) DESIGNATION OF PARTNER.—Each electing large partnership shall designate (in the manner prescribed by the Secretary) a partner (or other person) who shall have the sole authority to act on behalf of such partnership under this subchapter. In any case in which such a designation is not in effect, the Secretary may select any partner as the partner with such authority.

"(2) BINDING EFFECT.—An electing large partnership and all partners of such partnership shall be bound—

"(A) by actions taken under this subchapter by the partnership, and

"(B) by any decision in a proceeding brought under this subchapter.

"(c) PARTNERSHIPS HAVING PRINCIPAL PLACE OF BUSINESS OUTSIDE THE UNITED STATES.—For purposes of sections 6247 and 6252, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

"(d) TREATMENT WHERE PARTNERSHIP CEASES TO EXIST.—If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.

"(e) DATE DECISION BECOMES FINAL.—For purposes of this subchapter, the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the Claims Court becomes final.

"(f) PARTNERSHIPS IN CASES UNDER TITLE 11 OF THE UNITED STATES CODE.—The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any amount required to be paid under section 6242) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and—

"(1) for adjustment or assessment, 60 days thereafter, and

"(2) for collection, 6 months thereafter.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subchapter, including regulations—

"(1) to prevent abuse through manipulation of the provisions of this subchapter, and

"(2) providing that this subchapter shall not apply to any case described in section 6231(c)(1) (or the regulations prescribed thereunder) where the application of this subchapter to such a case would interfere with the effective and efficient enforcement of this title.

In any case to which this subchapter does not apply by reason of paragraph (2), rules similar to the rules of sections 6229(f) and 6255(f) shall apply."

(b) CLERICAL AMENDMENT.—The table of subchapters for chapter 63 is amended by adding at the end thereof the following new item:

"SUBCHAPTER D. Treatment of electing large partnerships."

SEC. 1223. DUE DATE FOR FURNISHING INFORMATION TO PARTNERS OF ELECTING LARGE PARTNERSHIPS.

(a) GENERAL RULE.—Subsection (b) of section 6031 (relating to copies to partners) is amended by adding at the end the following new sentence: "In the case of an electing large partnership (as defined in section 775), such information shall be furnished on or before the first March 15 following the close of such taxable year."

(b) TREATMENT AS INFORMATION RETURN.—Section 6724 is amended by adding at the end the following new subsection:

"(e) SPECIAL RULE FOR CERTAIN PARTNERSHIP RETURNS.—If any partnership return under section 6031(a) is required under section 6011(e) to be filed on magnetic media or in other machine-readable form, for purposes of this part, each schedule required to be included with such return with respect to each partner shall be treated as a separate information return."

SEC. 1224. RETURNS MAY BE REQUIRED ON MAGNETIC MEDIA.

Paragraph (2) of section 6011(e) (relating to returns on magnetic media) is amended by adding at the end thereof the following new sentence:

"Notwithstanding the preceding sentence, the Secretary shall require partnerships having more than 100 partners to file returns on magnetic media."

SEC. 1225. TREATMENT OF PARTNERSHIP ITEMS OF INDIVIDUAL RETIREMENT ACCOUNTS.

Subsection (b) of section 6012 is amended by adding at the end thereof the following new paragraph:

"(6) IRA SHARE OF PARTNERSHIP INCOME.—In the case of a trust which is exempt from taxation under section 408(e), for purposes of this section, the trust's distributive share of items of gross income and gain of any partnership to which subchapter C or D of chapter 63 applies shall be treated as equal to the trust's distributive share of the taxable income of such partnership."

SEC. 1226. EFFECTIVE DATE.

The amendments made by this part shall apply to partnership taxable years ending on or after December 31, 1997.

PART II—PROVISIONS RELATED TO TEFRA PARTNERSHIP PROCEEDINGS

SEC. 1231. TREATMENT OF PARTNERSHIP ITEMS IN DEFICIENCY PROCEEDINGS.

(a) IN GENERAL.—Subchapter C of chapter 63 is amended by adding at the end the following new section:

"SEC. 6234. DECLARATORY JUDGMENT RELATING TO TREATMENT OF ITEMS OTHER THAN PARTNERSHIP ITEMS WITH RESPECT TO AN OVERSHELTERED RETURN.

"(a) GENERAL RULE.—If—

"(1) a taxpayer files an oversheltered return for a taxable year,

"(2) the Secretary makes a determination with respect to the treatment of items (other than partnership items) of such taxpayer for such taxable year, and

"(3) the adjustments resulting from such determination do not give rise to a deficiency (as defined in section 6211) but would give rise to a deficiency if there were no net loss from partnership items,

the Secretary is authorized to send a notice of adjustment reflecting such determination to the taxpayer by certified or registered mail.

"(b) OVERSHELTERED RETURN.—For purposes of this section, the term 'oversheltered return' means an income tax return which—

"(1) shows no taxable income for the taxable year, and

"(2) shows a net loss from partnership items.

"(c) JUDICIAL REVIEW IN THE TAX COURT.—Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the day on which the notice of adjustment authorized in subsection (a) is mailed to the taxpayer, the taxpayer may file a petition with the Tax Court for redetermination of the adjustments. Upon the filing of such a petition, the Tax Court shall have jurisdiction to make a declaration with respect to all items (other than partnership items and affected items which require partner level determinations as described in section 6230(a)(2)(A)(i)) for the taxable year to which the notice of adjustment relates, in accordance with the principles of section 6214(a). Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(d) FAILURE TO FILE PETITION.—

"(1) IN GENERAL.—Except as provided in paragraph (2), if the taxpayer does not file a petition with the Tax Court within the time prescribed in subsection (c), the determination of the Secretary set forth in the notice of adjustment that was mailed to the taxpayer shall be deemed to be correct.

"(2) EXCEPTION.—Paragraph (1) shall not apply after the date that the taxpayer—

"(A) files a petition with the Tax Court within the time prescribed in subsection (c) with respect to a subsequent notice of adjustment relating to the same taxable year, or

"(B) files a claim for refund of an overpayment of tax under section 6511 for the taxable year involved.

If a claim for refund is filed by the taxpayer, then solely for purposes of determining (for the taxable year involved) the amount of any computational adjustment in connection with a partnership proceeding under this subchapter (other than under this section) or the amount of any deficiency attributable to affected items in a proceeding under section 6230(a)(2), the items that are the subject of the notice of adjustment shall be presumed to have been correctly reported on the taxpayer's return during the pendency of the refund claim (and, if within the time prescribed by section 6532 the taxpayer commences a civil action for refund under section 7422, until the decision in the refund action becomes final).

"(e) LIMITATIONS PERIOD.—

"(1) IN GENERAL.—Any notice to a taxpayer under subsection (a) shall be mailed before the expiration of the period prescribed by section 6501 (relating to the period of limitations on assessment).

"(2) SUSPENSION WHEN SECRETARY MAILS NOTICE OF ADJUSTMENT.—If the Secretary mails a notice of adjustment to the taxpayer for a taxable year, the period of limitations on the making of assessments shall be suspended for the period during which the Secretary is prohibited from making the assessment (and, in any event, if a proceeding in respect of the notice of adjustment is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

"(3) RESTRICTIONS ON ASSESSMENT.—Except as otherwise provided in section 6851, 6852, or 6861, no assessment of a deficiency with respect to any tax imposed by subtitle A attributable to any item (other than a partnership item or any item affected by a partnership item) shall be made—

"(A) until the expiration of the applicable 90-day or 150-day period set forth in subsection (c) for filing a petition with the Tax Court, or

"(B) if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.

"(f) FURTHER NOTICES OF ADJUSTMENT RESTRICTED.—If the Secretary mails a notice of adjustment to the taxpayer for a taxable year and the taxpayer files a petition with the Tax Court within the time prescribed in subsection (c), the Secretary may not mail another such notice to the taxpayer with respect to the same taxable year in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.

"(g) COORDINATION WITH OTHER PROCEEDINGS UNDER THIS SUBCHAPTER.—

"(1) IN GENERAL.—The treatment of any item that has been determined pursuant to subsection (c) or (d) shall be taken into account in determining the amount of any computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section), or the amount of any deficiency attributable to affected items in a proceeding under section 6230(a)(2), for the taxable year involved. Notwithstanding any other law or rule of law pertaining to the period of limitations on the making of assessments, for purposes of the preceding sentence, any adjustment made in accordance with this section shall be taken into account regardless of whether any assessment has been made with respect to such adjustment.

"(2) SPECIAL RULE IN CASE OF COMPUTATIONAL ADJUSTMENT.—In the case of a computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section), the provisions of paragraph (1) shall apply only if the computational adjustment is made within the period prescribed by section 6229 for assessing any tax under subtitle A which is attributable to any partnership item or affected item for the taxable year involved.

"(3) CONVERSION TO DEFICIENCY PROCEEDING.—If—

"(A) after the notice referred to in subsection (a) is mailed to a taxpayer for a taxable year but before the expiration of the period for filing a petition with the Tax Court under subsection (c) (or, if a petition is filed with the Tax Court, before the Tax Court makes a declaration for that taxable year), the treatment of any partnership item for the taxable year is finally determined, or any such item ceases to be a partnership item pursuant to section 6231(b), and

"(B) as a result of that final determination or cessation, a deficiency can be determined with respect to the items that are the subject of the notice of adjustment,

the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition filed in respect of the notice shall be treated as an action brought under section 6213.

"(4) FINALLY DETERMINED.—For purposes of this subsection, the treatment of partnership items shall be treated as finally determined if—

"(A) the Secretary enters into a settlement agreement (within the meaning of section 6224) with the taxpayer regarding such items,

"(B) a notice of final partnership administrative adjustment has been issued and—

"(i) no petition has been filed under section 6226 and the time for doing so has expired, or

"(ii) a petition has been filed under section 6226 and the decision of the court has become final, or

"(C) the period within which any tax attributable to such items may be assessed against the taxpayer has expired.

"(h) SPECIAL RULES IF SECRETARY INCORRECTLY DETERMINES APPLICABLE PROCEDURE.—

"(1) SPECIAL RULE IF SECRETARY ERRONEOUSLY MAILS NOTICE OF ADJUSTMENT.—If the Secretary erroneously determines that subchapter B does not apply to a taxable year of a taxpayer and consistent with that determination timely mails a notice of adjustment to the taxpayer pursuant to subsection (a) of this section, the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition that is filed in respect of the notice shall be treated as an action brought under section 6213.

"(2) SPECIAL RULE IF SECRETARY ERRONEOUSLY MAILS NOTICE OF DEFICIENCY.—If the Secretary erroneously determines that subchapter B applies to a taxable year of a taxpayer and consistent with that determination timely mails a notice of deficiency to the taxpayer pursuant to section 6212, the notice of deficiency shall be treated as a notice of adjustment under subsection (a) and any petition that is filed in respect of the notice shall be treated as an action brought under subsection (c)."

(b) TREATMENT OF PARTNERSHIP ITEMS IN DEFICIENCY PROCEEDINGS.—Section 6211 (defining deficiency) is amended by adding at the end the following new subsection:

"(c) COORDINATION WITH SUBCHAPTER C.—In determining the amount of any deficiency for purposes of this subchapter, adjustments to partnership items shall be made only as provided in subchapter C."

(c) CLERICAL AMENDMENT.—The table of sections for subchapter C of chapter 63 is amended by adding at the end the following new item:

"Sec. 6234. Declaratory judgment relating to treatment of items other than partnership items with respect to an oversheltered return."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 1232. PARTNERSHIP RETURN TO BE DETERMINATIVE OF AUDIT PROCEDURES TO BE FOLLOWED.

(a) IN GENERAL.—Section 6231 (relating to definitions and special rules) is amended by adding at the end the following new subsection:

"(g) PARTNERSHIP RETURN TO BE DETERMINATIVE OF WHETHER SUBCHAPTER APPLIES.—

"(1) DETERMINATION THAT SUBCHAPTER APPLIES.—If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such partnership (and its items) for such taxable year and to partners of such partnership.

"(2) DETERMINATION THAT SUBCHAPTER DOES NOT APPLY.—If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 1233. PROVISIONS RELATING TO STATUTE OF LIMITATIONS.

(a) SUSPENSION OF STATUTE WHERE UNTIMELY PETITION FILED.—Paragraph (1) of section 6229(d) (relating to suspension where Secretary makes administrative adjustment) is amended by striking all that follows "section 6226" and inserting the following: "(and, if a petition is filed under section 6226 with respect to such administrative adjustment, until the decision of the court becomes final), and".

(b) SUSPENSION OF STATUTE DURING BANKRUPTCY PROCEEDING.—Section 6229 is amended by adding at the end the following new subsection:

"(h) SUSPENSION DURING PENDENCY OF BANKRUPTCY PROCEEDING.—If a petition is filed naming a partner as a debtor in a bankruptcy proceeding under title 11 of the United States Code, the running of the period of limitations provided in this section with respect to such partner shall be suspended—

"(1) for the period during which the Secretary is prohibited by reason of such bankruptcy proceeding from making an assessment, and

"(2) for 60 days thereafter."

(c) TAX MATTERS PARTNER IN BANKRUPTCY.—Section 6229(b) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

"(2) SPECIAL RULE WITH RESPECT TO DEBTORS IN TITLE 11 CASES.—Notwithstanding any other law or rule of law, if an agreement is entered into under paragraph (1)(B) and the agreement is signed by a person who would be the tax matters partner but for the fact that, at the time that the agreement is executed, the person is a debtor in a bankruptcy proceeding under title 11 of the United States Code, such agreement shall be binding on all partners in the partnership unless the Secretary has been notified of the bankruptcy proceeding in accordance with regulations prescribed by the Secretary."

(d) EFFECTIVE DATES.—

(1) SUBSECTIONS (a) AND (b).—The amendments made by subsections (a) and (b) shall apply to partnership taxable years with respect to which the period under section 6229 of the Internal Revenue Code of 1986 for assessing tax has not expired on or before the date of the enactment of this Act.

(2) SUBSECTION (c).—The amendment made by subsection (c) shall apply to agreements entered into after the date of the enactment of this Act.

SEC. 1234. EXPANSION OF SMALL PARTNERSHIP EXCEPTION.

(a) IN GENERAL.—Clause (i) of section 6231(a)(1)(B) (relating to exception for small partnerships) is amended to read as follows:

"(i) IN GENERAL.—The term 'partnership' shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.''

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 1235. EXCLUSION OF PARTIAL SETTLEMENTS FROM 1-YEAR LIMITATION ON ASSESSMENT.

(a) IN GENERAL.—Subsection (f) of section 6229 (relating to items becoming nonpartnership items) is amended—

(1) by striking ''(f) ITEMS BECOMING NONPARTNERSHIP ITEMS.—If'' and inserting the following:

''(f) SPECIAL RULES.—

''(1) ITEMS BECOMING NONPARTNERSHIP ITEMS.—If'',

(2) by moving the text of such subsection 2 ems to the right, and

(3) by adding at the end the following new paragraph:

''(2) SPECIAL RULE FOR PARTIAL SETTLEMENT AGREEMENTS.— If a partner enters into a settlement agreement with the Secretary with respect to the treatment of some of the partnership items in dispute for a partnership taxable year but other partnership items for such year remain in dispute, the period of limitations for assessing any tax attributable to the settled items shall be determined as if such agreement had not been entered into.''

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to settlements entered into after the date of the enactment of this Act.

SEC. 1236. EXTENSION OF TIME FOR FILING A REQUEST FOR ADMINISTRATIVE ADJUSTMENT.

(a) IN GENERAL.—Section 6227 (relating to administrative adjustment requests) is amended by redesignating subsections (b) and (c) as subsections (c) and (d), respectively, and by inserting after subsection (a) the following new subsection:

''(b) SPECIAL RULE IN CASE OF EXTENSION OF PERIOD OF LIMITATIONS UNDER SECTION 6229.—The period prescribed by subsection (a)(1) for filing of a request for an administrative adjustment shall be extended—

''(1) for the period within which an assessment may be made pursuant to an agreement (or any extension thereof) under section 6229(b), and

''(2) for 6 months thereafter.''

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC. 1237. AVAILABILITY OF INNOCENT SPOUSE RELIEF IN CONTEXT OF PARTNERSHIP PROCEEDINGS.

(a) IN GENERAL.—Subsection (a) of section 6230 is amended by adding at the end the following new paragraph:

''(3) SPECIAL RULE IN CASE OF ASSERTION BY PARTNER'S SPOUSE OF INNOCENT SPOUSE RELIEF.—

''(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6013(e) applies with respect to a liability that is attributable to any adjustment to a partnership item, then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessment specified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making any such reassessment shall not expire before the expiration of 60 days after the date of such abatement.

"(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6013(e) have been satisfied. For purposes of such determination, the treatment of partnership items under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

"(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph."

(b) CLAIMS FOR REFUND.—Subsection (c) of section 6230 is amended by adding at the end the following new paragraph:

"(5) RULES FOR SEEKING INNOCENT SPOUSE RELIEF.—

"(A) IN GENERAL.—The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6013(e) from a liability that is attributable to an adjustment to a partnership item.

"(B) TIME FOR FILING CLAIM.—Any claim under subparagraph (A) shall be filed within 6 months after the day on which the Secretary mails to the spouse the notice of computational adjustment referred to in subsection (a)(3)(A).

"(C) SUIT IF CLAIM NOT ALLOWED.—If the claim under subparagraph (B) is not allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

"(D) PRIOR DETERMINATIONS ARE BINDING.—For purposes of any claim or suit under this paragraph, the treatment of partnership items under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive."

(c) TECHNICAL AMENDMENTS.—

(1) Paragraph (1) of section 6230(a) is amended by striking "paragraph (2)" and inserting "paragraph (2) or (3)".

(2) Subsection (a) of section 6503 is amended by striking "section 6230(a)(2)(A)" and inserting "paragraph (2)(A) or (3) of section 6230(a)".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC. 1238. DETERMINATION OF PENALTIES AT PARTNERSHIP LEVEL.

(a) IN GENERAL.—Section 6221 (relating to tax treatment determined at partnership level) is amended by striking "item" and inserting "item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item)".

(b) CONFORMING AMENDMENTS.—

(1) Subsection (f) of section 6226 is amended—

(A) by striking "relates and" and inserting "relates,", and

(B) by inserting before the period ", and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item".

(2) Clause (i) of section 6230(a)(2)(A) is amended to read as follows:

"(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or".

(3)(A) Subparagraph (A) of section 6230(a)(3), as added by section 14317, is amended by inserting "(including any liability for any penalty, addition to tax, or additional amount relating to such adjustment)" after "partnership item".

(B) Subparagraph (B) of such section is amended by inserting "(and the applicability of any penalties, additions to tax, or additional amounts)" after "partnership items".

(C) Subparagraph (A) of section 6230(c)(5), as added by section 14317, is amended by inserting before the period "(including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment)".

(D) Subparagraph (D) of section 6230(c)(5), as added by section 14317, is amended by inserting "(and the applicability of any penalties, additions to tax, or additional amounts)" after "partnership items".

(4) Paragraph (1) of section 6230(c) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or", and by adding at the end the following new subparagraph:

"(C) the Secretary erroneously imposed any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item."

(5) So much of subparagraph (A) of section 6230(c)(2) as precedes "shall be filed" is amended to read as follows:

"(A) UNDER PARAGRAPH (1) (A) OR (C).—Any claim under subparagraph (A) or (C) of paragraph (1)".

(6) Paragraph (4) of section 6230(c) is amended by adding at the end the following: "In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sen-

tence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 1239. PROVISIONS RELATING TO COURT JURISDICTION, ETC.

(a) TAX COURT JURISDICTION TO ENJOIN PREMATURE ASSESSMENTS OF DEFICIENCIES ATTRIBUTABLE TO PARTNERSHIP ITEMS.—Subsection (b) of section 6225 is amended by striking "the proper court." and inserting "the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action or proceeding under this subsection unless a timely petition for a readjustment of the partnership items for the taxable year has been filed and then only in respect of the adjustments that are the subject of such petition."

(b) JURISDICTION TO CONSIDER STATUTE OF LIMITATIONS WITH RESPECT TO PARTNERS.—Paragraph (1) of section 6226(d) is amended by adding at the end the following new sentence:

"Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion."

(c) TAX COURT JURISDICTION TO DETERMINE OVERPAYMENTS ATTRIBUTABLE TO AFFECTED ITEMS.—

(1) Paragraph (6) of section 6230(d) is amended by striking "(or an affected item)".

(2) Paragraph (3) of section 6512(b) is amended by adding at the end the following new sentence:

"In the case of a credit or refund relating to an affected item (within the meaning of section 6231(a)(5)), the preceding sentence shall be applied by substituting the periods under sections 6229 and 6230(d) for the periods under section 6511(b)(2), (c), and (d)."

(d) VENUE ON APPEAL.—

(1) Paragraph (1) of section 7482(b) is amended by striking "or" at the end of subparagraph (D), by striking the period at the end of subparagraph (E) and inserting ", or", and by inserting after subparagraph (E) the following new subparagraph:

"(F) in the case of a petition under section 6234(c)—

"(i) the legal residence of the petitioner if the petitioner is not a corporation, and

"(ii) the place or office applicable under subparagraph (B) if the petitioner is a corporation."

(2) The last sentence of section 7482(b)(1) is amended by striking "or 6228(a)" and inserting ", 6228(a), or 6234(c)".

(e) OTHER PROVISIONS.—

(1) Subsection (c) of section 7459 is amended by striking "or section 6228(a)" and inserting ", 6228(a), or 6234(c)".

(2) Subsection (o) of section 6501 is amended by adding at the end the following new paragraph:

"(3) For declaratory judgment relating to treatment of items other than partnership items with respect to an oversheltered return, see section 6234."

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years ending after the date of the enactment of this Act.

SEC. 1240. TREATMENT OF PREMATURE PETITIONS FILED BY NOTICE PARTNERS OR 5-PERCENT GROUPS.

(a) IN GENERAL.—Subsection (b) of section 6226 (relating to judicial review of final partnership administrative adjustments) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) TREATMENT OF PREMATURE PETITIONS.—If—

"(A) a petition for a readjustment of partnership items for the taxable year involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

"(B) no action is brought under paragraph (1) during the 60-day period described therein with respect to such taxable year which is not dismissed,

such petition shall be treated for purposes of paragraph (1) as filed on the last day of such 60-day period."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to petitions filed after the date of the enactment of this Act.

SEC. 1241. BONDS IN CASE OF APPEALS FROM CERTAIN PROCEEDING.

(a) IN GENERAL.—Subsection (b) of section 7485 (relating to bonds to stay assessment of collection) is amended—

(1) by inserting "penalties," after "any interest,", and

(2) by striking "aggregate of such deficiencies" and inserting "aggregate liability of the parties to the action".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

SEC. 1242. SUSPENSION OF INTEREST WHERE DELAY IN COMPUTATIONAL ADJUSTMENT RESULTING FROM CERTAIN SETTLEMENTS.

(a) IN GENERAL.—Subsection (c) of section 6601 (relating to interest on underpayment, nonpayment, or extension of time for payment, of tax) is amended by adding at the end the following new sentence: "In the case of a settlement under section 6224(c) which results in the conversion of partnership items to nonpartnership items pursuant to section 6231(b)(1)(C), the preceding sentence shall apply to a computational adjustment resulting from such settlement in the same manner as if such adjustment were a deficiency and such settlement were a waiver referred to in the preceding sentence."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to adjustments with respect to partnership taxable years beginning after the date of the enactment of this Act.

SEC. 1243. SPECIAL RULES FOR ADMINISTRATIVE ADJUSTMENT REQUESTS WITH RESPECT TO BAD DEBTS OR WORTHLESS SECURITIES.

(a) GENERAL RULE.—Section 6227 (relating to administrative adjustment requests) is amended by adding at the end the following new subsection:

"(e) REQUESTS WITH RESPECT TO BAD DEBTS OR WORTHLESS SECURITIES.—In the case of that portion of any request for an administrative adjustment which relates to the deductibility by the partnership under section 166 of a debt as a debt which became worthless, or under section 165(g) of a loss from worthlessness of a security, the period prescribed in subsection (a)(1) shall be 7 years from the last day for filing the partnership return for the year with respect to which such request is made (determined without regard to extensions)."

(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) shall take effect as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

(2) TREATMENT OF REQUESTS FILED BEFORE DATE OF ENACTMENT.—In the case of that portion of any request (filed before the date of the enactment of this Act) for an administrative adjustment which relates to the deductibility of a debt as a debt which became worthless or the deductibility of a loss from the worthlessness of a security—

(A) paragraph (2) of section 6227(a) of the Internal Revenue Code of 1986 shall not apply,

(B) the period for filing a petition under section 6228 of the Internal Revenue Code of 1986 with respect to such request shall not expire before the date 6 months after the date of the enactment of this Act, and

(C) such a petition may be filed without regard to whether there was a notice of the beginning of an administrative proceeding or a final partnership administrative adjustment.

PART III—PROVISION RELATING TO CLOSING OF PARTNERSHIP TAXABLE YEAR WITH RESPECT TO DECEASED PARTNER, ETC.

SEC. 1246. CLOSING OF PARTNERSHIP TAXABLE YEAR WITH RESPECT TO DECEASED PARTNER, ETC.

(a) GENERAL RULE.—Subparagraph (A) of section 706(c)(2) (relating to disposition of entire interest) is amended to read as follows:

"(A) DISPOSITION OF ENTIRE INTEREST.—The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)."

(b) CLERICAL AMENDMENT.—The paragraph heading for paragraph (2) of section 706(c) is amended to read as follows:

"(2) TREATMENT OF DISPOSITIONS.—".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years beginning after December 31, 1997.

Subtitle D—Provisions Relating to Real Estate Investment Trusts

SEC. 1251. CLARIFICATION OF LIMITATION ON MAXIMUM NUMBER OF SHAREHOLDERS.

(a) RULES RELATING TO DETERMINATION OF OWNERSHIP.—

(1) FAILURE TO ISSUE SHAREHOLDER DEMAND LETTER NOT TO DISQUALIFY REIT.—Section 857(a) (relating to requirements applicable to real estate investment trusts) is amended by striking paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(2) SHAREHOLDER DEMAND LETTER REQUIREMENT; PENALTY.—Section 857 (relating to taxation of real estate investment trusts and their beneficiaries) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) REAL ESTATE INVESTMENT TRUSTS TO ASCERTAIN OWNERSHIP.—

"(1) IN GENERAL.—Each real estate investment trust shall each taxable year comply with regulations prescribed by the Secretary for the purposes of ascertaining the actual ownership of the outstanding shares, or certificates of beneficial interest, of such trust.

"(2) FAILURE TO COMPLY.—

"(A) IN GENERAL.—If a real estate investment trust fails to comply with the requirements of paragraph (1) for a taxable year, such trust shall pay (on notice and demand by the Secretary and in the same manner as tax) a penalty of $25,000.

"(B) INTENTIONAL DISREGARD.—If any failure under paragraph (1) is due to intentional disregard of the requirement under paragraph (1), the penalty under subparagraph (A) shall be $50,000.

"(C) FAILURE TO COMPLY AFTER NOTICE.—The Secretary may require a real estate investment trust to take such actions as the Secretary determines appropriate to ascertain actual ownership if the trust fails to meet the requirements of paragraph (1). If the trust fails to take such actions, the trust shall pay (on notice and demand by the Secretary and in the same manner as tax) an additional penalty equal to the penalty determined under subparagraph (A) or (B), whichever is applicable.

"(D) REASONABLE CAUSE.—No penalty shall be imposed under this paragraph with respect to any failure if it is shown that such failure is due to reasonable cause and not to willful neglect."

(b) COMPLIANCE WITH CLOSELY HELD PROHIBITION.—

(1) IN GENERAL.—Section 856 (defining real estate investment trust) is amended by adding at the end the following new subsection:

"(k) REQUIREMENT THAT ENTITY NOT BE CLOSELY HELD TREATED AS MET IN CERTAIN CASES.—A corporation, trust, or association—

"(1) which for a taxable year meets the requirements of section 857(f)(1), and

"(2) which does not know, or exercising reasonable diligence would not have known, whether the entity failed to meet the requirement of subsection (a)(6),

shall be treated as having met the requirement of subsection (a)(6) for the taxable year."

(2) CONFORMING AMENDMENT.—Paragraph (6) of section 856(a) is amended by inserting "subject to the provisions of subsection (k)," before "which is not".

SEC. 1252. DE MINIMIS RULE FOR TENANT SERVICES INCOME.

(a) IN GENERAL.—Paragraph (2) of section 856(d) (defining rents from real property) is amended by striking subparagraph (C) and the last sentence and inserting:

"(C) any impermissible tenant service income (as defined in paragraph (7))."

(b) IMPERMISSIBLE TENANT SERVICE INCOME.—Section 856(d) is amended by adding at the end the following new paragraph:

"(7) IMPERMISSIBLE TENANT SERVICE INCOME.—For purposes of paragraph (2)(C)—

"(A) IN GENERAL.—The term 'impermissible tenant service income' means, with respect to any real or personal property, any amount received or accrued directly or indirectly by the real estate investment trust for—

"(i) services furnished or rendered by the trust to the tenants of such property, or

"(ii) managing or operating such property.

"(B) DISQUALIFICATION OF ALL AMOUNTS WHERE MORE THAN DE MINIMIS AMOUNT.—If the amount described in subparagraph (A) with respect to a property for any taxable year exceeds 1 percent of all amounts received or accrued during such taxable year directly or indirectly by the real estate investment trust with respect to such property, the impermissible tenant service income of the trust with respect to the property shall include all such amounts.

"(C) EXCEPTIONS.—For purposes of subparagraph (A)—

"(i) services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income shall not be treated as furnished, rendered, or provided by the trust, and

"(ii) there shall not be taken into account any amount which would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).

"(D) AMOUNT ATTRIBUTABLE TO IMPERMISSIBLE SERVICES.—For purposes of subparagraph (A), the amount treated as received for any service (or management or operation) shall not be less than 150 percent of the direct cost of the trust in furnishing or rendering the service (or providing the management or operation).

"(E) COORDINATION WITH LIMITATIONS.—For purposes of paragraphs (2) and (3) of subsection (c), amounts described in subparagraph (A) shall be included in the gross income of the corporation, trust, or association."

SEC. 1253. ATTRIBUTION RULES APPLICABLE TO TENANT OWNERSHIP.

Section 856(d)(5) (relating to constructive ownership of stock) is amended by adding at the end the following: "For purposes of paragraph (2)(B), section 318(a)(3)(A) shall be applied under the preceding sentence in the case of a partnership by taking into account only partners who own (directly or indirectly) 25 percent or more of the capital interest, or the profits interest, in the partnership."

SEC. 1254. CREDIT FOR TAX PAID BY REIT ON RETAINED CAPITAL GAINS.

(a) GENERAL RULE.—Paragraph (3) of section 857(b) (relating to capital gains) is amended by redesignating subparagraph (D) as subparagraph (E) and by inserting after subparagraph (C) the following new subparagraph:

"(D) TREATMENT BY SHAREHOLDERS OF UNDISTRIBUTED CAPITAL GAINS.—

"(i) Every shareholder of a real estate investment trust at the close of the trust's taxable year shall include, in computing his long-term capital gains in his return for his taxable year in which the last day of the trust's taxable year falls, such amount as the trust shall designate in respect of such shares in a written notice mailed to its shareholders at any time prior to the expiration of 60 days after the close of its taxable year (or mailed to its shareholders or holders of beneficial interests with its annual report for the taxable year), but the amount so includible by any shareholder shall not exceed that part of the amount subjected to tax in subparagraph (A)(ii) which he would have received if all of such amount had been distributed as capital gain dividends by the trust to the holders of such shares at the close of its taxable year.

"(ii) For purposes of this title, every such shareholder shall be deemed to have paid, for his taxable year under clause (i), the tax imposed by subparagraph (A)(ii) on the amounts required by this subparagraph to be included in respect of such shares in computing his long-term capital gains for that year; and such shareholders shall be allowed credit or refund as the case may be, for the tax so deemed to have been paid by him.

"(iii) The adjusted basis of such shares in the hands of the holder shall be increased with respect to the amounts required by this subparagraph to be included in computing his long-term capital gains, by the difference between the amount of such includible gains and the tax deemed paid by such shareholder in respect of such shares under clause (ii).

"(iv) In the event of such designation, the tax imposed by subparagraph (A)(ii) shall be paid by the real estate investment trust within 30 days after the close of its taxable year.

"(v) The earnings and profits of such real estate investment trust, and the earnings and profits of any such shareholder which is a corporation, shall be appropriately adjusted in accordance with regulations prescribed by the Secretary.

"(vi) As used in this subparagraph, the terms 'shares' and 'shareholders' shall include beneficial interests and holders of beneficial interests, respectively."

(b) CONFORMING AMENDMENTS.—

(1) Clause (i) of section 857(b)(7)(A) is amended by striking "subparagraph (B)" and inserting "subparagraph (B) or (D)".

(2) Clause (iii) of section 852(b)(3)(D) is amended by striking "by 65 percent" and all that follows and inserting "by the difference between the amount of such includible gains and the tax deemed paid by such shareholder in respect of such shares under clause (ii)."

SEC. 1255. REPEAL OF 30-PERCENT GROSS INCOME REQUIREMENT.

(a) GENERAL RULE.—Subsection (c) of section 856 (relating to limitations) is amended—

(1) by adding "and" at the end of paragraph (3),

(2) by striking paragraphs (4) and (8), and

(3) by redesignating paragraphs (5), (6), and (7) as paragraphs (4), (5), and (6), respectively.

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (G) of section 856(c)(5), as redesignated by subsection (a), is amended by striking "and such agreement shall be treated as a security for purposes of paragraph (4)(A)".

(2) Paragraph (5) of section 857(b) is amended by striking "section 856(c)(7)" and inserting "section 856(c)(6)".

(3) Subparagraph (C) of section 857(b)(6) is amended by striking "section 856(c)(6)(B)" and inserting "section 856(c)(5)(B)".

SEC. 1256. MODIFICATION OF EARNINGS AND PROFITS RULES FOR DETERMINING WHETHER REIT HAS EARNINGS AND PROFITS FROM NON-REIT YEAR.

Subsection (d) of section 857 is amended by adding at the end the following new paragraph:

"(3) DISTRIBUTIONS TO MEET REQUIREMENTS OF SUBSECTION (a)(2)(B).—Any distribution which is made in order to comply with the requirements of subsection (a)(2)(B)—

"(A) shall be treated for purposes of this subsection and subsection (a)(2)(B) as made from the earliest accumulated earnings and profits (other than earnings and profits to which subsection (a)(2)(A) applies) rather than the most recently accumulated earnings and profits, and

"(B) to the extent treated under subparagraph (A) as made from accumulated earnings and profits, shall not be treated as a distribution for purposes of subsection (b)(2)(B)."

SEC. 1257. TREATMENT OF FORECLOSURE PROPERTY.

(a) GRACE PERIODS.—

(1) INITIAL PERIOD.—Paragraph (2) of section 856(e) (relating to special rules for foreclosure property) is amended by striking "on the date which is 2 years after the date the trust acquired such property" and inserting "as of the close of the 3d taxable year following the taxable year in which the trust acquired such property".

(2) EXTENSION.—Paragraph (3) of section 856(e) is amended—

(A) by striking "or more extensions" and inserting "extension", and

(B) by striking the last sentence and inserting: "Any such extension shall not extend the grace period beyond the close of the 3d taxable year following the last taxable year in the period under paragraph (2)."

(b) REVOCATION OF ELECTION.—Paragraph (5) of section 856(e) is amended by striking the last sentence and inserting: "A real estate investment trust may revoke any such election for a taxable year by filing the revocation (in the manner provided by the Secretary) on or before the due date (including any extension of time) for filing its return of tax under this chapter for the taxable year. If a trust revokes an election for any property, no election may be made by the trust under this paragraph with respect to the property for any subsequent taxable year."

(c) CERTAIN ACTIVITIES NOT TO DISQUALIFY PROPERTY.—Paragraph (4) of section 856(e) is amended by adding at the end the following new flush sentence:

"For purposes of subparagraph (C), property shall not be treated as used in a trade or business by reason of any activities of the real estate investment trust with respect to such property to the extent that such activities would not result in amounts received or accrued, directly or indirectly, with respect to such property being treated as other than rents from real property."

SEC. 1258. PAYMENTS UNDER HEDGING INSTRUMENTS.

Section 856(c)(5)(G) (relating to treatment of certain interest rate agreements), as redesignated by section 1255, is amended to read as follows:

"(G) TREATMENT OF CERTAIN HEDGING INSTRUMENTS.—Except to the extent provided by regulations, any—

"(i) payment to a real estate investment trust under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets, and

"(ii) gain from the sale or other disposition of any such investment,

shall be treated as income qualifying under paragraph (2)."

SEC. 1259. EXCESS NONCASH INCOME.

Section 857(e)(2) (relating to determination of amount of excess noncash income) is amended—

(1) by striking subparagraph (B),

(2) by striking the period at the end of subparagraph (C) and inserting a comma,

(3) by redesignating subparagraph (C) (as amended by paragraph (2)) as subparagraph (B), and

(4) by adding at the end the following new subparagraphs:

"(C) the amount (if any) by which—

"(i) the amounts includible in gross income with respect to instruments to which section 860E(a) or 1272 applies, exceed

"(ii) the amount of money and the fair market value of other property received during the taxable year under such instruments, and

"(D) amounts includible in income by reason of cancellation of indebtedness."

SEC. 1260. PROHIBITED TRANSACTION SAFE HARBOR.

Clause (iii) of section 857(b)(6)(C) (relating to certain sales not to constitute prohibited transactions) is amended by striking "(other than foreclosure property)" in subclauses (I) and (II) and inserting "(other than sales of foreclosure property or sales to which section 1033 applies)".

SEC. 1261. SHARED APPRECIATION MORTGAGES.

(a) BANKRUPTCY SAFE HARBOR.—Section 856(j) (relating to treatment of shared appreciation mortgages) is amended by redesignating paragraph (4) as paragraph (5) and by inserting after paragraph (3) the following new paragraph:

"(4) COORDINATION WITH 4-YEAR HOLDING PERIOD.—

"(A) IN GENERAL.—For purposes of section 857(b)(6)(C), if a real estate investment trust is treated as having sold secured property under paragraph (3)(A), the trust shall be treated as having held such property for at least 4 years if—

"(i) the secured property is sold or otherwise disposed of pursuant to a case under title 11 of the United States Code,

"(ii) the seller is under the jurisdiction of the court in such case, and

"(iii) the disposition is required by the court or is pursuant to a plan approved by the court.

"(B) EXCEPTION.—Subparagraph (A) shall not apply if—

"(i) the secured property was acquired by the trust with the intent to evict or foreclose, or

"(ii) the trust knew or had reason to know that default on the obligation described in paragraph (5)(A) would occur."

(b) CLARIFICATION OF DEFINITION OF SHARED APPRECIATION PROVISION.—Clause (ii) of section 856(j)(5)(A) is amended by inserting before the period "or appreciation in value as of any specified date".

SEC. 1262. WHOLLY OWNED SUBSIDIARIES.

Section 856(i)(2) (defining qualified REIT subsidiary) is amended by striking “at all times during the period such corporation was in existence”.

SEC. 1263. EFFECTIVE DATE.

The amendments made by this part shall apply to taxable years beginning after the date of the enactment of this Act.

Subtitle E—Provisions Relating to Regulated Investment Companies

SEC. 1271. REPEAL OF 30-PERCENT GROSS INCOME LIMITATION.

(a) GENERAL RULE.—Subsection (b) of section 851 (relating to limitations) is amended by striking paragraph (3), by adding “and” at the end of paragraph (2), and by redesignating paragraph (4) as paragraph (3).

(b) TECHNICAL AMENDMENTS.—

(1) The material following paragraph (3) of section 851(b) (as redesignated by subsection (a)) is amended—

(A) by striking out “paragraphs (2) and (3)” and inserting “paragraph (2)”, and

(B) by striking out the last sentence thereof.

(2) Subsection (c) of section 851 is amended by striking “subsection (b)(4)” each place it appears (including the heading) and inserting “subsection (b)(3)”.

(3) Subsection (d) of section 851 is amended by striking “subsections (b)(4)” and inserting “subsections (b)(3)”.

(4) Paragraph (1) of section 851(e) is amended by striking “subsection (b)(4)” and inserting “subsection (b)(3)”.

(5) Paragraph (4) of section 851(e) is amended by striking “subsections (b)(4)” and inserting “subsections (b)(3)”.

(6) Section 851 is amended by striking subsection (g) and redesignating subsection (h) as subsection (g).

(7) Subsection (g) of section 851 (as redesignated by paragraph (6)) is amended by striking paragraph (3).

(8) Section 817(h)(2) is amended—

(A) by striking “851(b)(4)” in subparagraph (A) and inserting “851(b)(3)”, and

(B) by striking “851(b)(4)(A)(i)” in subparagraph (B) and inserting “851(b)(3)(A)(i)”.

(9) Section 1092(f)(2) is amended by striking “Except for purposes of section 851(b)(3), the” and inserting “The”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

Subtitle F—Taxpayer Protections

SEC. 1281. REASONABLE CAUSE EXCEPTION FOR CERTAIN PENALTIES.

(a) INFORMATION ON DEDUCTIBLE EMPLOYEE CONTRIBUTIONS.—Subsection (g) of section 6652 (relating to information required in connection with deductible employee contributions) is amended by adding at the end the following new sentence: "No penalty shall be imposed under this subsection on any failure which is shown to be due to reasonable cause and not willful neglect."

(b) REPORTS ON STATUS AS QUALIFIED SMALL BUSINESS.—Subsection (k) of section 6652 (relating to failure to make reports required under section 1202) is amended by adding at the end the following new sentence: "No penalty shall be imposed under this subsection on any failure which is shown to be due to reasonable cause and not willful neglect."

(c) RETURNS OF PERSONAL HOLDING COMPANY TAX BY FOREIGN CORPORATIONS.—Section 6683 (relating to failure of foreign corporation to file return of personal holding company tax) is amended by adding at the end the following new sentence: "No penalty shall be imposed under this section on any failure which is shown to be due to reasonable cause and not willful neglect."

(d) FAILURE TO MAKE REQUIRED PAYMENTS.—Subparagraph (A) of section 7519(f)(4) is amended by adding at the end the following new sentence: "No penalty shall be imposed under this subparagraph on any failure which is shown to be due to reasonable cause and not willful neglect."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1282. CLARIFICATION OF PERIOD FOR FILING CLAIMS FOR REFUNDS.

(a) IN GENERAL.—Paragraph (3) of section 6512(b) (relating to overpayment determined by Tax Court) is amended by adding at the end the following flush sentence:

> "In a case described in subparagraph (B) where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to claims for credit or refund for taxable years ending after the date of the enactment of this Act.

SEC. 1283. REPEAL OF AUTHORITY TO DISCLOSE WHETHER PROSPECTIVE JUROR HAS BEEN AUDITED.

(a) IN GENERAL.—Subsection (h) of section 6103 (relating to disclosure to certain Federal officers and employees for purposes of tax administration, etc.) is amended by striking paragraph (5) and by redesignating paragraph (6) as paragraph (5).

(b) CONFORMING AMENDMENT.—Paragraph (4) of section 6103(p) is amended by striking "(h)(6)" each place it appears and inserting "(h)(5)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to judicial proceedings commenced after the date of the enactment of this Act.

SEC. 1284. CLARIFICATION OF STATUTE OF LIMITATIONS.

(a) IN GENERAL.—Subsection (a) of section 6501 (relating to limitations on assessment and collection) is amended by adding at the end thereof the following new sentence: "For purposes of this chapter, the term 'return' means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1285. AWARDING OF ADMINISTRATIVE COSTS.

(a) RIGHT TO APPEAL TAX COURT DECISION.—Subsection (f) of section 7430 (relating to right of appeal) is amended by adding at the end the following new paragraph:

"(3) APPEAL OF TAX COURT DECISION.—An order of the Tax Court disposing of a petition under paragraph (2) shall be reviewable in the same manner as a decision of the Tax Court, but only with respect to the matters determined in such order."

(b) PERIOD FOR APPLYING TO IRS FOR COSTS.—Subsection (b) of section 7430 (relating to limitations) is amended by adding at the end the following new paragraph:

"(5) PERIOD FOR APPLYING TO IRS FOR ADMINISTRATIVE COSTS.—An award may be made under subsection (a) by the Internal Revenue Service for reasonable administrative costs only if the prevailing party files an application with the Internal Revenue Service for such costs before the 91st day after the date on which the final decision of the Internal Revenue Service as to the determination of the tax, interest, or penalty is mailed to such party."

(c) PERIOD FOR PETITIONING OF TAX COURT FOR REVIEW OF DENIAL OF COSTS.—Paragraph (2) of section 7430(f) (relating to right of appeal) is amended—

(1) by striking "appeal to" and inserting "the filing of a petition for review with", and

(2) by adding at the end the following new sentence: "If the Secretary sends by certified or registered mail a notice of such decision to the petitioner, no proceeding in the Tax Court may be initiated under this paragraph unless such petition is filed before the 91st day after the date of such mailing."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to civil actions or proceedings commenced after the date of the enactment of this Act.

SEC. 1286. PENALTY FOR UNAUTHORIZED INSPECTION OF TAX RETURNS OR TAX RETURN INFORMATION.

(a) IN GENERAL.—Part I of subchapter A of chapter 75 (relating to crimes, other offenses, and forfeitures) is amended by adding after section 7213 the following new section:

"SEC. 7213A. UNAUTHORIZED INSPECTION OF RETURNS OR RETURN INFORMATION.

"(a) PROHIBITIONS.—

"(1) FEDERAL EMPLOYEES AND OTHER PERSONS.—It shall be unlawful for—

"(A) any officer or employee of the United States, or

"(B) any person described in section 6103(n) or an officer or employee of any such person, willfully to inspect, except as authorized in this title, any return or return information.

"(2) STATE AND OTHER EMPLOYEES.—It shall be unlawful for any person (not described in paragraph (1)) willfully to inspect, except as authorized in this title, any return or return information acquired by such person or another person under a provision of section 6103 referred to in section 7213(a)(2).

"(b) PENALTY.—

"(1) IN GENERAL.—Any violation of subsection (a) shall be punishable upon conviction by a fine in any amount not exceeding $1,000, or imprisonment of not more than 1 year, or both, together with the costs of prosecution.

"(2) FEDERAL OFFICERS OR EMPLOYEES.—An officer or employee of the United States who is convicted of any violation of subsection (a) shall, in addition to any other punishment, be dismissed from office or discharged from employment.

"(c) DEFINITIONS.—For purposes of this section, the terms 'inspect', 'return', and 'return information' have the respective meanings given such terms by section 6103(b)."

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 7213(a) is amended by inserting "(5)," after "(m)(2), (4),".

(2) The table of sections for part I of subchapter A of chapter 75 is amended by inserting after the item relating to section 7213 the following new item:

"Sec. 7213A. Unauthorized inspection of returns or return information."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to violations occurring on and after the date of the enactment of this Act.

SEC. 1287. CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION OF RETURNS AND RETURN INFORMATION; NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.

(a) CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION.—Subsection (a) of section 7431 is amended—

(1) by striking "DISCLOSURE" in the headings for paragraphs (1) and (2) and inserting "INSPECTION OR DISCLOSURE", and

(2) by striking "discloses" in paragraphs (1) and (2) and inserting "inspects or discloses".

(b) NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.—Section 7431 is amended by redesignating subsections (e) and (f) as subsections (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) NOTIFICATION OF UNLAWFUL INSPECTION AND DISCLOSURE.—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—

"(1) paragraph (1) or (2) of section 7213(a),

"(2) section 7213A(a), or

"(3) subparagraph (B) of section 1030(a)(2) of title 18, United States Code,

the Secretary shall notify such taxpayer as soon as practicable of such inspection or disclosure."

(c) No Damages for Inspection Requested by Taxpayer.—Subsection (b) of section 7431 is amended to read as follows:

"(b) Exceptions.—No liability shall arise under this section with respect to any inspection or disclosure—

"(1) which results from a good faith, but erroneous, interpretation of section 6103, or

"(2) which is requested by the taxpayer."

(d) Conforming Amendments.—

(1) Subsections (c)(1)(A), (c)(1)(B)(i), and (d) of section 7431 are each amended by inserting "inspection or" before "disclosure".

(2) Clause (ii) of section 7431(c)(1)(B) is amended by striking "willful disclosure or a disclosure" and inserting "willful inspection or disclosure or an inspection or disclosure".

(3) Subsection (f) of section 7431, as redesignated by subsection (b), is amended to read as follows:

"(f) Definitions.—For purposes of this section, the terms 'inspect', 'inspection', 'return', and 'return information' have the respective meanings given such terms by section 6103(b)."

(4) The section heading for section 7431 is amended by inserting "**inspection or**" before "**disclosure**".

(5) The table of sections for subchapter B of chapter 76 is amended by inserting "inspection or" before "disclosure" in the item relating to section 7431.

(6) Paragraph (2) of section 7431(g), as redesignated by subsection (b), is amended by striking "any use" and inserting "any inspection or use".

(e) Effective Date.—The amendments made by this section shall apply to inspections and disclosures occurring on and after the date of the enactment of this Act.

TITLE XIII—SIMPLIFICATION PROVISIONS RELATING TO ESTATE AND GIFT TAXES

SEC. 1301. GIFTS TO CHARITIES EXEMPT FROM GIFT TAX FILING REQUIREMENTS.

(a) In General.—Section 6019 is amended by striking "or" at the end of paragraph (1), by adding "or" at the end of paragraph (2), and by inserting after paragraph (2) the following new paragraph:

"(3) a transfer with respect to which a deduction is allowed under section 2522, except that this paragraph shall apply with respect to a transfer of property (other than a transfer described in section 2522(d)) only if the entire value of such property is allowed as a deduction under section 2522,".

(b) Effective Date.—The amendment made by this section shall apply to gifts made after the date of the enactment of this Act.

SEC. 1302. CLARIFICATION OF WAIVER OF CERTAIN RIGHTS OF RECOVERY.

(a) Amendment to Section 2207A.—Paragraph (2) of section 2207A(a) (relating to right of recovery in the case of certain marital deduction property) is amended to read as follows:

"(2) DECEDENT MAY OTHERWISE DIRECT.—Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property."

(b) AMENDMENT TO SECTION 2207B.—Paragraph (2) of section 2207B(a) (relating to right of recovery where decedent retained interest) is amended to read as follows:

"(2) DECEDENT MAY OTHERWISE DIRECT.—Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the estates of decedents dying after the date of the enactment of this Act.

SEC. 1303. TRANSITIONAL RULE UNDER SECTION 2056A.

(a) GENERAL RULE.—In the case of any trust created under an instrument executed before the date of the enactment of the Revenue Reconciliation Act of 1990, such trust shall be treated as meeting the requirements of paragraph (1) of section 2056A(a) of the Internal Revenue Code of 1986 if the trust instrument requires that all trustees of the trust be individual citizens of the United States or domestic corporations.

(b) EFFECTIVE DATE.—The provisions of subsection (a) shall take effect as if included in the provisions of section 11702(g) of the Revenue Reconciliation Act of 1990.

SEC. 1304. CLARIFICATIONS RELATING TO DISCLAIMERS.

(a) PARTIAL TRANSFER-TYPE DISCLAIMERS PERMITTED.—Paragraph (3) of section 2518(c) (relating to certain transfers treated as disclaimers) is amended by inserting "(or an undivided portion of such interest)" after "entire interest in the property".

(b) RETENTION OF INTEREST BY DECEDENT'S SPOUSE PERMITTED IN TRANSFER-TYPE DISCLAIMERS.—Paragraph (3) of section 2518(c) is amended by adding at the end the following new flush sentence:

"For purposes of the preceding sentence, a written transfer by the spouse of the decedent of property to a trust shall not fail to be treated as a transfer of such spouse's interest in such property by reason of such spouse having an interest in such trust."

(c) DISCLAIMERS ARE EFFECTIVE FOR INCOME TAX PURPOSES.—Subsection (a) of section 2518 is amended by inserting "and subtitle A" after "this subtitle" each place it appears.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers creating an interest in the person disclaiming, and disclaimers, made after the date of the enactment of this Act.

SEC. 1305. INCREASE OF AMOUNT OF LAPSE OF GENERAL POWER OF APPOINTMENT NOT TREATED AS RELEASE FOR PURPOSES OF ESTATE AND GIFT TAX (5 OR 5 POWER).

(a) ESTATE TAX.—Subparagraph (A) of section 2041(b)(2) (relating to lapse of power) is amended by striking "$5,000" and inserting "$10,000".

(b) GIFT TAX.—Paragraph (1) of section 2514(e) (relating to lapse of power) is amended by striking "$5,000" and inserting "$10,000".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1306. TREATMENT FOR ESTATE TAX PURPOSES OF SHORT-TERM OBLIGATIONS HELD BY NONRESIDENT ALIENS.

(a) IN GENERAL.—Subsection (b) of section 2105 is amended by striking "and" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting ", and", and by inserting after paragraph (3) the following new paragraph:

"(4) obligations which would be original issue discount obligations as defined in section 871(g)(1) but for subparagraph (B)(i) thereof, if any interest thereon (were such interest received by the decedent at the time of his death) would not be effectively connected with the conduct of a trade or business within the United States."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

SEC. 1307. CERTAIN REVOCABLE TRUSTS TREATED AS PART OF ESTATE.

(a) IN GENERAL.—Subpart A of part I of subchapter J (relating to estates, trusts, beneficiaries, and decedents) is amended by adding at the end the following new section:

"SEC. 646. CERTAIN REVOCABLE TRUSTS TREATED AS PART OF ESTATE.

"(a) GENERAL RULE.—For purposes of this subtitle, if both the executor (if any) of an estate and the trustee of a qualified revocable trust elect the treatment provided in this section, such trust shall be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable date.

"(b) DEFINITIONS.—For purposes of subsection (a)—

"(1) QUALIFIED REVOCABLE TRUST.—The term 'qualified revocable trust' means any trust (or portion thereof) which was treated under section 676 as owned by the decedent of the estate referred to in subsection (a) by reason of a power in the grantor (determined without regard to section 672(e)).

"(2) APPLICABLE DATE.—The term 'applicable date' means—

"(A) if no return of tax imposed by chapter 11 is required to be filed, the date which is 2 years after the date of the decedent's death, and

"(B) if such a return is required to be filed, the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11.

"(c) ELECTION.—The election under subsection (a) shall be made not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions) and, once made, shall be irrevocable."

(b) COMPARABLE TREATMENT UNDER GENERATION-SKIPPING TAX.—Paragraph (1) of section 2652(b) is amended by adding at the end the following new sentence: "Such term shall not include any trust during any period the trust is treated as part of an estate under section 646."

(c) CLERICAL AMENDMENT.—The table of sections for such subpart A is amended by adding at the end the following new item:

"Sec. 646. Certain revocable trusts treated as part of estate."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 1308. DISTRIBUTIONS DURING FIRST 65 DAYS OF TAXABLE YEAR OF ESTATE.

(a) IN GENERAL.—Subsection (b) of section 663 (relating to distributions in first 65 days of taxable year) is amended by inserting "an estate or" before "a trust" each place it appears.

(b) CONFORMING AMENDMENT.—Paragraph (2) of section 663(b) is amended by striking "the fiduciary of such trust" and inserting "the executor of such estate or the fiduciary of such trust (as the case may be)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1309. SEPARATE SHARE RULES AVAILABLE TO ESTATES.

(a) IN GENERAL.—Subsection (c) of section 663 (relating to separate shares treated as separate trusts) is amended—

(1) by inserting before the last sentence the following new sentence: "Rules similar to the rules of the preceding provisions of this subsection shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than 1 beneficiary as separate estates.", and

(2) by inserting "or estates" after "trusts" in the last sentence.

(b) CONFORMING AMENDMENT.—The subsection heading of section 663(c) is amended by inserting "ESTATES OR" before "TRUSTS".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

SEC. 1310. EXECUTOR OF ESTATE AND BENEFICIARIES TREATED AS RELATED PERSONS FOR DISALLOWANCE OF LOSSES, ETC.

(a) DISALLOWANCE OF LOSSES.—Subsection (b) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended by striking "or" at the end of paragraph (11), by striking the period at the end of paragraph (12) and inserting "; or", and by adding at the end the following new paragraph:

"(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate."

(b) ORDINARY INCOME FROM GAIN FROM SALE OF DEPRECIABLE PROPERTY.—Subsection (b) of section 1239 is amended by striking the period at the end of paragraph (2) and inserting ", and" and by adding at the end the following new paragraph:

"(3) except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1311. LIMITATION ON TAXABLE YEAR OF ESTATES.

(a) IN GENERAL.—Section 645 (relating to taxable year of trusts) is amended to read as follows:

"SEC. 645. TAXABLE YEAR OF ESTATES AND TRUSTS.

"(a) ESTATES.—For purposes of this subtitle, the taxable year of an estate shall be a year ending on October 31, November 30, or December 31.

"(b) TRUSTS.—

"(1) IN GENERAL.—For purposes of this subtitle, the taxable year of any trust shall be the calendar year.

"(2) EXCEPTION FOR TRUSTS EXEMPT FROM TAX AND CHARITABLE TRUSTS.—Paragraph (1) shall not apply to a trust exempt from taxation under section 501(a) or to a trust described in section 4947(a)(1)."

(b) CLERICAL AMENDMENT.—The table of sections for subpart A of part I of subchapter J of chapter 1 is amended by striking the item relating to section 645 and inserting the following new item:

"Sec. 645. Taxable year of estates and trusts."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

SEC. 1312. TREATMENT OF FUNERAL TRUSTS.

(a) IN GENERAL.—Subpart F of part I of subchapter J of chapter 1 is amended by adding at the end the following new section:

"SEC. 684. TREATMENT OF FUNERAL TRUSTS.

"(a) IN GENERAL.—In the case of a qualified funeral trust—

"(1) subparts B, C, D, and E shall not apply, and

"(2) no deduction shall be allowed by section 642(b).

"(b) QUALIFIED FUNERAL TRUST.—For purposes of this subsection, the term 'qualified funeral trust' means any trust (other than a foreign trust) if—

"(1) the trust arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services,

"(2) the sole purpose of the trust is to hold, invest, and reinvest funds in the trust and to use such funds solely to make payments for such services or property for the benefit of the beneficiaries of the trust,

"(3) the only beneficiaries of such trust are individuals who have entered into contracts described in paragraph (1) to have such services or property provided at their death,

"(4) the only contributions to the trust are contributions by or for the benefit of such beneficiaries,

"(5) the trustee elects the application of this subsection, and

"(6) the trust would (but for the election described in paragraph (5)) be treated as owned by the beneficiaries under subpart E.

"(c) DOLLAR LIMITATION ON CONTRIBUTIONS.—

"(1) IN GENERAL.—The term 'qualified funeral trust' shall not include any trust which accepts aggregate contributions by or for the benefit of an individual in excess of $7,000.

"(2) RELATED TRUSTS.—For purposes of paragraph (1), all trusts having trustees which are related persons shall be treated as 1 trust. For purposes of the preceding sentence, persons are related if—

"(A) the relationship between such persons is described in section 267 or 707(b),

"(B) such persons are treated as a single employer under subsection (a) or (b) of section 52, or

"(C) the Secretary determines that treating such persons as related is necessary to prevent avoidance of the purposes of this section.

"(3) INFLATION ADJUSTMENT.—In the case of any contract referred to in subsection (b)(1) which is entered into during any calendar year after 1998, the dollar amount referred to paragraph (1) shall be increased by an amount equal to—

"(A) such dollar amount, multiplied by

"(B) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year, by substituting 'calendar year 1997' for 'calendar year 1992' in subparagraph (B) thereof.

If any dollar amount after being increased under the preceding sentence is not a multiple of $100, such dollar amount shall be rounded to the nearest multiple of $100.

"(d) APPLICATION OF RATE SCHEDULE.—Section 1(e) shall be applied to each qualified funeral trust by treating each beneficiary's interest in each such trust as a separate trust.

"(e) TREATMENT OF AMOUNTS REFUNDED TO BENEFICIARY ON CANCELLATION.—No gain or loss shall be recognized to a beneficiary described in subsection (b)(3) of any qualified funeral trust by reason of any payment from such trust to such beneficiary by reason of cancellation of a contract referred to in subsection (b)(1). If any payment referred to in the preceding sentence consists of property other than money, the basis of such property in the hands of such beneficiary shall be the same as the trust's basis in such property immediately before the payment.

"(f) SIMPLIFIED REPORTING.—The Secretary may prescribe rules for simplified reporting of all trusts having a single trustee."

(b) CLERICAL AMENDMENT.—The table of sections for subpart F of part I of subchapter J of chapter 1 is amended by adding at the end the following new item:

"Sec. 684. Treatment of funeral trusts."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1313. ADJUSTMENTS FOR GIFTS WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) GENERAL RULE.—Section 2035 is amended to read as follows:

"SEC. 2035. ADJUSTMENTS FOR CERTAIN GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

"(a) INCLUSION OF CERTAIN PROPERTY IN GROSS ESTATE.—If—

"(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and

"(2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,

the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

"(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH.—The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

"(c) OTHER RULES RELATING TO TRANSFERS WITHIN 3 YEARS OF DEATH.—

"(1) IN GENERAL.—For purposes of—

"(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

"(B) section 2032A (relating to special valuation of certain farms, etc., real property), and

"(C) subchapter C of chapter 64 (relating to lien for taxes),

the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

"(2) COORDINATION WITH SECTION 6166.—An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of paragraph (1).

"(3) MARITAL AND SMALL TRANSFERS.—Paragraph (1) shall not apply to any transfer (other than a transfer with respect to a life insurance policy) made during a calendar year to any donee if the decedent was not required by section 6019 (other than by reason of section 6019(2)) to file any gift tax return for such year with respect to transfers to such donee.

"(d) EXCEPTION.—Subsection (a) shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

"(e) TREATMENT OF CERTAIN TRANSFERS FROM REVOCABLE TRUSTS.—For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)) shall be treated as a transfer made directly by the decedent."

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter A of chapter 11 is amended by striking "gifts" in the item relating to section 2035 and inserting "certain gifts".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying after the date of the enactment of this Act.

SEC. 1314. CLARIFICATION OF TREATMENT OF SURVIVOR ANNUITIES UNDER QUALIFIED TERMINABLE INTEREST RULES.

(a) IN GENERAL.—Subparagraph (C) of section 2056(b)(7) is amended by inserting "(or, in the case of an interest in an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033)" after "section 2039".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

SEC. 1315. TREATMENT UNDER QUALIFIED DOMESTIC TRUST RULES OF FORMS OF OWNERSHIP WHICH ARE NOT TRUSTS.

(a) IN GENERAL.—Subsection (c) of section 2056A (defining qualified domestic trust) is amended by adding at the end the following new paragraph:

"(3) TRUST.—To the extent provided in regulations prescribed by the Secretary, the term 'trust' includes other arrangements which have substantially the same effect as a trust."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

SEC. 1316. OPPORTUNITY TO CORRECT CERTAIN FAILURES UNDER SECTION 2032A.

(a) GENERAL RULE.—Paragraph (3) of section 2032A(d) (relating to modification of election and agreement to be permitted) is amended to read as follows:

"(3) MODIFICATION OF ELECTION AND AGREEMENT TO BE PERMITTED.—The Secretary shall prescribe procedures which provide that in any case in which the executor makes an election under paragraph (1) (and submits the agreement referred to in paragraph (2)) within the time prescribed therefor, but—

"(A) the notice of election, as filed, does not contain all required information, or

"(B) signatures of 1 or more persons required to enter into the agreement described in paragraph (2) are not included on the agreement as filed, or the agreement does not contain all required information,

the executor will have a reasonable period of time (not exceeding 90 days) after notification of such failures to provide such information or signatures."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to the estates of decedents dying after the date of the enactment of this Act.

SEC. 1317. AUTHORITY TO WAIVE REQUIREMENT OF UNITED STATES TRUSTEE FOR QUALIFIED DOMESTIC TRUSTS.

(a) IN GENERAL.—Subparagraph (A) of section 2056A(a)(1) is amended by inserting "except as provided in regulations prescribed by the Secretary," before "requires".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

TITLE XIV—SIMPLIFICATION PROVISIONS RELATING TO EXCISE TAXES, TAX-EXEMPT BONDS, AND OTHER MATTERS

Subtitle A—Excise Tax Simplification

PART I—EXCISE TAXES ON HEAVY TRUCKS AND LUXURY CARS

SEC. 1401. INCREASE IN DE MINIMIS LIMIT FOR AFTER-MARKET ALTERATIONS FOR HEAVY TRUCKS AND LUXURY CARS.

(a) IN GENERAL.—Sections 4003(a)(3)(C) and 4051(b)(2)(B) (relating to exceptions) are each amended by striking "$200" and inserting "$1,000".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply to installations on vehicles sold after the date of the enactment of this Act.

SEC. 1402. CREDIT FOR TIRE TAX IN LIEU OF EXCLUSION OF VALUE OF TIRES IN COMPUTING PRICE.

(a) IN GENERAL.—Subsection (e) of section 4051 is amended to read as follows:

"(e) CREDIT AGAINST TAX FOR TIRE TAX.—If—

"(1) tires are sold on or in connection with the sale of any article, and

"(2) tax is imposed by this subchapter on the sale of such tires,

there shall be allowed as a credit against the tax imposed by this subchapter an amount equal to the tax (if any) imposed by section 4071 on such tires."

(b) CONFORMING AMENDMENT.—Subparagraph (B) of section 4052(b)(1) is amended by striking clause (iii), by adding "and" at the end of clause (ii), and by redesignating clause (iv) as clause (iii).

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1998.

PART II—PROVISIONS RELATED TO DISTILLED SPIRITS, WINES, AND BEER

SEC. 1411. CREDIT OR REFUND FOR IMPORTED BOTTLED DISTILLED SPIRITS RETURNED TO DISTILLED SPIRITS PLANT.

(a) IN GENERAL.—Section 5008(c)(1) (relating to distilled spirits returned to bonded premises) is amended by striking "withdrawn from bonded premises on payment or determination of tax" and inserting "on which tax has been determined or paid".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1412. AUTHORITY TO CANCEL OR CREDIT EXPORT BONDS WITHOUT SUBMISSION OF RECORDS.

(a) IN GENERAL.—Section 5175(c) (relating to cancellation of credit of export bonds) is amended by striking "on the submission of" and all that follows and inserting "if there is such proof of exportation as the Secretary may by regulations require."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1413. REPEAL OF REQUIRED MAINTENANCE OF RECORDS ON PREMISES OF DISTILLED SPIRITS PLANT.

(a) IN GENERAL.—Section 5207(c) (relating to preservation and inspection) is amended by striking "shall be kept on the premises where the operations covered by the record are carried on and".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1414. FERMENTED MATERIAL FROM ANY BREWERY MAY BE RECEIVED AT A DISTILLED SPIRITS PLANT.

(a) IN GENERAL.—Section 5222(b)(2) (relating to receipt) is amended to read as follows:

"(2) beer conveyed without payment of tax from brewery premises, beer which has been lawfully removed from brewery premises upon determination of tax, or".

(b) CLARIFICATION OF AUTHORITY TO PERMIT REMOVAL OF BEER WITHOUT PAYMENT OF TAX FOR USE AS DISTILLING MATERIAL.—Section 5053 (relating to exemptions) is amended by redesignating subsection (f) as subsection (i) and by inserting after subsection (e) the following new subsection:

"(f) REMOVAL FOR USE AS DISTILLING MATERIAL.—Subject to such regulations as the Secretary may prescribe, beer may be removed from a brewery without payment of tax to any distilled spirits plant for use as distilling material."

(c) CLARIFICATION OF REFUND AND CREDIT OF TAX.—Section 5056 (relating to refund and credit of tax, or relief from liability) is amended—

(1) by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) BEER RECEIVED AT A DISTILLED SPIRITS PLANT.—Any tax paid by any brewer on beer produced in the United States may be refunded or credited to the brewer, without interest, or if the tax has not been paid, the brewer may be relieved of liability therefor, under regulations as the Secretary may prescribe, if such beer is received on the bonded premises of a distilled spirits plant pursuant to the provisions of section 5222(b)(2), for use in the production of distilled spirits.", and

(2) by striking "or rendering unmerchantable" in subsection (d) (as so redesignated) and inserting "rendering unmerchantable, or receipt on the bonded premises of a distilled spirits plant".

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1415. REPEAL OF REQUIREMENT FOR WHOLESALE DEALERS IN LIQUORS TO POST SIGN.

(a) IN GENERAL.—Section 5115 (relating to sign required on premises) is hereby repealed.

(b) CONFORMING AMENDMENTS.—

(1) Section 5681(a) is amended by striking ", and every wholesale dealer in liquors," and by striking "section 5115(a) or".

(2) Section 5681(c) is amended—

(A) by striking "or wholesale liquor establishment, on which no sign required by section 5115(a) or" and inserting "on which no sign required by", and

(B) by striking "or wholesale liquor establishment, or who" and inserting "or who".

(3) The table of sections for subpart D of part II of subchapter A of chapter 51 is amended by striking the item relating to section 5115.

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 1416. REFUND OF TAX TO WINE RETURNED TO BOND NOT LIMITED TO UNMERCHANTABLE WINE.

(a) IN GENERAL.—Section 5044(a) (relating to refund of tax on unmerchantable wine) is amended by striking "as unmerchantable".

(b) CONFORMING AMENDMENTS.—

(1) Section 5361 is amended by striking "unmerchantable".

(2) The section heading for section 5044 is amended by striking "**unmerchantable**".

(3) The item relating to section 5044 in the table of sections for subpart C of part I of subchapter A of chapter 51 is amended by striking "unmerchantable".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1417. USE OF ADDITIONAL AMELIORATING MATERIAL IN CERTAIN WINES.

(a) IN GENERAL.—Section 5384(b)(2)(D) (relating to ameliorated fruit and berry wines) is amended by striking "loganberries, currants, or gooseberries," and inserting "any fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry)".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1418. DOMESTICALLY PRODUCED BEER MAY BE WITHDRAWN FREE OF TAX FOR USE OF FOREIGN EMBASSIES, LEGATIONS, ETC.

(a) IN GENERAL.—Section 5053 (relating to exemptions), as amended by section 1414(b), is amended by inserting after subsection (f) the following new subsection:

"(g) REMOVALS FOR USE OF FOREIGN EMBASSIES, LEGATIONS, ETC.—

"(1) IN GENERAL.—Subject to such regulations as the Secretary may prescribe—

"(A) beer may be withdrawn from the brewery without payment of tax for transfer to any customs bonded warehouse for entry pending withdrawal therefrom as provided in subparagraph (B), and

"(B) beer entered into any customs bonded warehouse under subparagraph (A) may be withdrawn for consumption in the United States by, and for the official and family use of, such foreign governments, organizations, and individuals as are entitled to withdraw imported beer from such warehouses free of tax.

Beer transferred to any customs bonded warehouse under subparagraph (A) shall be entered, stored, and accounted for in such warehouse under such regulations and bonds as the Secretary may prescribe, and may be withdrawn therefrom by such governments, organizations, and individuals free of tax under the same conditions and procedures as imported beer.

"(2) OTHER RULES TO APPLY.—Rules similar to the rules of paragraphs (2) and (3) of section 5362(e) shall apply for purposes of this subsection."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1419. BEER MAY BE WITHDRAWN FREE OF TAX FOR DESTRUCTION.

(a) IN GENERAL.—Section 5053 (relating to exemptions), as amended by section 1418(a), is amended by inserting after subsection (g) the following new subsection:

"(h) REMOVALS FOR DESTRUCTION.—Subject to such regulations as the Secretary may prescribe, beer may be removed from the brewery without payment of tax for destruction."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1420. AUTHORITY TO ALLOW DRAWBACK ON EXPORTED BEER WITHOUT SUBMISSION OF RECORDS.

(a) IN GENERAL.—The first sentence of section 5055 (relating to drawback of tax on beer) is amended by striking "found to have been paid" and all that follows and inserting "paid on such beer if there is such proof of exportation as the Secretary may by regulations require."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1421. TRANSFER TO BREWERY OF BEER IMPORTED IN BULK WITHOUT PAYMENT OF TAX.

(a) IN GENERAL.—Part II of subchapter G of chapter 51 is amended by adding at the end the following new section:

"SEC. 5418. BEER IMPORTED IN BULK.

"Beer imported or brought into the United States in bulk containers may, under such regulations as the Secretary may prescribe, be withdrawn from customs custody and transferred in such bulk containers to the premises of a brewery without payment of the internal revenue tax imposed on such beer. The proprietor of a brewery to which such beer is transferred shall become liable for the tax on the beer withdrawn from customs custody under this section upon release of the beer from customs custody, and the importer, or the person bringing such beer into the United States, shall thereupon be relieved of the liability for such tax."

(b) CLERICAL AMENDMENT.—The table of sections for such part II is amended by adding at the end the following new item:

"Sec. 5418. Beer imported in bulk."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

SEC. 1422. TRANSFER TO BONDED WINE CELLARS OF WINE IMPORTED IN BULK WITHOUT PAYMENT OF TAX.

(a) IN GENERAL.—Part II of subchapter F of chapter 51 is amended by inserting after section 5363 the following new section:

"SEC. 5364. WINE IMPORTED IN BULK.

"Wine imported or brought into the United States in bulk containers may, under such regulations as the Secretary may prescribe, be withdrawn from customs custody and transferred in such bulk containers to the premises of a bonded wine cellar without payment of the internal revenue tax imposed on such wine. The proprietor of a bonded wine cellar to which such wine is transferred shall become liable for the tax on the wine withdrawn from customs custody under this section upon release of the wine from customs custody, and the importer, or the person bringing such wine into the United States, shall thereupon be relieved of the liability for such tax."

(b) CLERICAL AMENDMENT.—The table of sections for such part II is amended by inserting after the item relating to section 5363 the following new item:

"Sec. 5364. Wine imported in bulk."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the 1st day of the 1st calendar quarter that begins at least 90 days after the date of the enactment of this Act.

PART III—OTHER EXCISE TAX PROVISIONS

SEC. 1431. AUTHORITY TO GRANT EXEMPTIONS FROM REGISTRATION REQUIREMENTS.

(a) IN GENERAL.—Section 4222(b)(2) (relating to export) is amended—

(1) by striking "in the case of any sale or resale for export,", and

(2) by striking "EXPORT" and inserting "UNDER REGULATIONS".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take effect on the date of the enactment of this Act.

SEC. 1432. REPEAL OF EXPIRED PROVISIONS.

(a) PIGGY-BACK TRAILERS.—Section 4051 (relating to imposition of tax on heavy trucks and trailers sold at retail) is amended by striking subsection (d) and by redesignating subsection (e) as subsection (d).

(b) DEEP SEABED MINING.—

(1) IN GENERAL.—Subchapter F of chapter 36 (relating to tax on removal of hard mineral resources from deep seabed) is hereby repealed.

(2) CONFORMING AMENDMENT.—The table of subchapters for chapter 36 is amended by striking the item relating to subchapter F.

(c) OZONE-DEPLETING CHEMICALS.—

(1) Paragraph (1) of section 4681(b) is amended by striking subparagraphs (B) and (C) and inserting the following new subparagraph:

"(B) BASE TAX AMOUNT.—The base tax amount for purposes of subparagraph (A) with respect to any sale or use during any calendar year after 1995 shall be $5.35 increased by 45 cents for each year after 1995."

(2) Subsection (g) of section 4682 is amended to read as follows:

"(g) CHEMICALS USED AS PROPELLANTS IN METERED-DOSE INHALERS.—

"(1) EXEMPTION FROM TAX.—

"(A) IN GENERAL.—No tax shall be imposed by section 4681 on—

"(i) any use of any substance as a propellant in metered-dose inhalers, or

"(ii) any qualified sale by the manufacturer, producer, or importer of any substance.

"(B) QUALIFIED SALE.—For purposes of subparagraph (A), the term 'qualified sale' means any sale by the manufacturer, producer, or importer of any substance—

"(i) for use by the purchaser as a propellant in metered dose inhalers, or

"(ii) for resale by the purchaser to a 2d purchaser for such use by the 2d purchaser.

The preceding sentence shall apply only if the manufacturer, producer, and importer, and the 1st and 2d purchasers (if any) meet such registration requirements as may be prescribed by the Secretary.

"(2) OVERPAYMENTS.—If any substance on which tax was paid under this subchapter is used by any person as a propellant in metered-dose inhalers, credit or refund without interest shall be allowed to such person in an amount equal to the tax so paid. Amounts payable under the preceding sentence with respect to uses during the taxable year shall be treated as described in section 34(a) for such year unless claim thereof has been timely filed under this paragraph."

Subtitle B—Tax-Exempt Bond Provisions

SEC. 1441. REPEAL OF $100,000 LIMITATION ON UNSPENT PROCEEDS UNDER 1-YEAR EXCEPTION FROM REBATE.

Subclause (I) of section 148(f)(4)(B)(ii) (relating to additional period for certain bonds) is amended by striking "the lesser of 5 percent of the proceeds of the issue or $100,000" and inserting "5 percent of the proceeds of the issue".

SEC. 1442. EXCEPTION FROM REBATE FOR EARNINGS ON BONA FIDE DEBT SERVICE FUND UNDER CONSTRUCTION BOND RULES.

Subparagraph (C) of section 148(f)(4) is amended by adding at the end the following new clause:

"(xvii) TREATMENT OF BONA FIDE DEBT SERVICE FUNDS.—If the spending requirements of clause (ii) are met with respect to the available construction proceeds of a construction issue, then paragraph (2) shall not apply to earnings on a bona fide debt service fund for such issue."

SEC. 1443. REPEAL OF DEBT SERVICE-BASED LIMITATION ON INVESTMENT IN CERTAIN NONPURPOSE INVESTMENTS.

Subsection (d) of section 148 (relating to special rules for reasonably required reserve or replacement fund) is amended by striking paragraph (3).

SEC. 1444. REPEAL OF EXPIRED PROVISIONS.

(a) Paragraph (2) of section 148(c) is amended by striking subparagraph (B) and by redesignating subparagraphs (C), (D), and (E) as subparagraphs (B), (C), and (D), respectively.

(b) Paragraph (4) of section 148(f) is amended by striking subparagraph (E).

SEC. 1445. EFFECTIVE DATE.

The amendments made by this subtitle shall apply to bonds issued after the date of the enactment of this Act.

Subtitle C—Tax Court Procedures

SEC. 1451. OVERPAYMENT DETERMINATIONS OF TAX COURT.

(a) APPEAL OF ORDER.—Paragraph (2) of section 6512(b) (relating to jurisdiction to enforce) is amended by adding at the end the following new sentence: "An order of the Tax Court disposing of a motion under this paragraph shall be reviewable in the same manner as a decision of the Tax Court, but only with respect to the matters determined in such order."

(b) DENIAL OF JURISDICTION REGARDING CERTAIN CREDITS AND REDUCTIONS.—Subsection (b) of section 6512 (relating to overpayment determined by Tax Court) is amended by adding at the end the following new paragraph:

"(4) DENIAL OF JURISDICTION REGARDING CERTAIN CREDITS AND REDUCTIONS.—The Tax Court shall have no jurisdiction under this subsection to restrain or review any credit or reduction made by the Secretary under section 6402."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

SEC. 1452. REDETERMINATION OF INTEREST PURSUANT TO MOTION.

(a) IN GENERAL.—Subsection (c) of section 7481 (relating to jurisdiction over interest determinations) is amended to read as follows:

"(c) JURISDICTION OVER INTEREST DETERMINATIONS.—

"(1) IN GENERAL.—Notwithstanding subsection (a), if, within 1 year after the date the decision of the Tax Court becomes final under subsection (a) in a case to which this subsection applies, the taxpayer files a motion in the Tax Court for a redetermination of the amount of interest involved, then the Tax Court may reopen the case solely to determine whether the taxpayer has made an overpayment of such interest or the Secretary has made an underpayment of such interest and the amount thereof.

"(2) CASES TO WHICH THIS SUBSECTION APPLIES.—This subsection shall apply where—

"(A)(i) an assessment has been made by the Secretary under section 6215 which includes interest as imposed by this title, and

"(ii) the taxpayer has paid the entire amount of the deficiency plus interest claimed by the Secretary, and

"(B) the Tax Court finds under section 6512(b) that the taxpayer has made an overpayment.

"(3) SPECIAL RULES.—If the Tax Court determines under this subsection that the taxpayer has made an overpayment of interest or that the Secretary has made an underpayment of interest, then that determination shall be treated under section 6512(b)(1) as a determination of an overpayment of tax. An order of the Tax Court redetermining interest, when entered upon the records of the court, shall be reviewable in the same manner as a decision of the Tax Court."

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect on the date of the enactment of this Act.

SEC. 1453. APPLICATION OF NET WORTH REQUIREMENT FOR AWARDS OF LITIGATION COSTS.

(a) IN GENERAL.—Paragraph (4) of section 7430(c) (defining prevailing party) is amended by adding at the end thereof the following new subparagraph:

"(D) SPECIAL RULES FOR APPLYING NET WORTH REQUIREMENT.—In applying the requirements of section 2412(d)(2)(B) of title 28, United States Code, for purposes of subparagraph (A)(iii) of this paragraph—

"(i) the net worth limitation in clause (i) of such section shall apply to—

"(I) an estate but shall be determined as of the date of the decedent's death, and

"(II) a trust but shall be determined as of the last day of the taxable year involved in the proceeding, and

"(ii) individuals filing a joint return shall be treated as 1 individual for purposes of clause (i) of such section, except in the case of a spouse relieved of liability under section 6013(e)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to proceedings commenced after the date of the enactment of this Act.

SEC. 1454. PROCEEDINGS FOR DETERMINATION OF EMPLOYMENT STATUS.

(a) IN GENERAL.—Subchapter B of chapter 76 (relating to proceedings by taxpayers and third parties) is amended by redesignating section 7435 as section 7436 and by inserting after section 7434 the following new section:

"SEC. 7435. PROCEEDINGS FOR DETERMINATION OF EMPLOYMENT STATUS.

"(a) CREATION OF REMEDY.—If, in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that—

"(1) one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or

"(2) such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such an individual,

upon the filing of an appropriate pleading, the Tax Court may determine whether such a determination by the Secretary is correct. Any such determination by the Tax Court shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(b) LIMITATIONS.—

"(1) PETITIONER.—A pleading may be filed under this section only by the person for whom the services are performed.

"(2) TIME FOR FILING ACTION.—If the Secretary sends by certified or registered mail notice to the petitioner of a determination by the Secretary described in subsection (a), no proceeding may be initiated under this section with respect to such determination unless the pleading is filed before the 91st day after the date of such mailing.

"(3) NO ADVERSE INFERENCE FROM TREATMENT WHILE ACTION IS PENDING.—If, during the pendency of any proceeding brought under this section, the petitioner changes his treatment for employment tax purposes of any individual whose employment status as an employee is involved in such proceeding (or of any individual holding a substantially similar position) to treatment as an employee, such change shall not be taken into account in the Tax Court's determination under this section.

"(c) SMALL CASE PROCEDURES.—

"(1) IN GENERAL.—At the option of the petitioner, concurred in by the Tax Court or a division thereof before the hearing of the case, proceedings under this section may (notwithstanding the provisions of section 7453) be conducted subject to the rules of evidence, practice, and procedure applicable under section 7463 if the amount of employment taxes placed in dispute is $10,000 or less for each calendar quarter involved.

"(2) FINALITY OF DECISIONS.—A decision entered in any proceeding conducted under this subsection shall not be reviewed in any other court and shall not be treated as a precedent for any other case not involving the same petitioner and the same determinations.

"(3) CERTAIN RULES TO APPLY.—Rules similar to the rules of the last sentence of subsection (a), and subsections (c), (d), and (e), of section 7463 shall apply to proceedings conducted under this subsection.

"(d) SPECIAL RULES.—

"(1) RESTRICTIONS ON ASSESSMENT AND COLLECTION PENDING ACTION, ETC.—The principles of subsections (a), (b), and (d) of section 6213, section 6214(a), section 6503(a), and section 6512 shall apply to proceedings brought under this section in the same manner as if the Secretary's determination described in subsection (a) were a notice of deficiency.

"(2) AWARDING OF COSTS AND CERTAIN FEES.—Section 7430 shall apply to proceedings brought under this section.

"(e) EMPLOYMENT TAX.—The term 'employment tax' means any tax imposed by subtitle C."

(b) CONFORMING AMENDMENTS.—

(1) Subsection (d) of section 6511 is amended by adding at the end the following new paragraph:

"(7) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO SELF-EMPLOYMENT TAX IN CERTAIN CASES.—If—

"(A) the claim for credit or refund relates to an overpayment of the tax imposed by chapter 2 (relating to the tax on self-employment income) attributable to Tax Court determination in a proceeding under section 7435, and

"(B) the allowance of a credit or refund of such overpayment is otherwise prevented by the operation of any law or rule of law other than section 7122 (relating to compromises),

such credit or refund may be allowed or made if claim therefor is filed on or before the last day of the second year after the calendar year in which such determination becomes final."

(2) Sections 7453 and 7481(b) are each amended by striking "section 7463" and inserting "section 7435(c) or 7463".

(3) The table of sections for subchapter B of chapter 76 is amended by striking the last item and inserting the following:

"Sec. 7435. Proceedings for determination of employment status.
"Sec. 7436. Cross references."

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect on the date of the enactment of this Act.

Subtitle D—Other Provisions

SEC. 1461. EXTENSION OF DUE DATE OF FIRST QUARTER ESTIMATED TAX PAYMENT BY PRIVATE FOUNDATIONS.

(a) IN GENERAL.—Paragraph (3) of section 6655(g) is amended by adding at the end the following new sentence: "In the case of a private foundation, subsection (c)(2) shall be applied by substituting 'May 15' for 'April 15'."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply for purposes of determining underpayments of estimated tax for taxable years beginning after the date of the enactment of this Act.

SEC. 1462. CLARIFICATION OF AUTHORITY TO WITHHOLD PUERTO RICO INCOME TAXES FROM SALARIES OF FEDERAL EMPLOYEES.

(a) IN GENERAL.—Subsection (c) of section 5517 of title 5, United States Code, is amended by striking "or territory or possession" and inserting ", territory, possession, or commonwealth".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on January 1, 1998.

SEC. 1463. CERTAIN NOTICES DISREGARDED UNDER PROVISION INCREASING INTEREST RATE ON LARGE CORPORATE UNDERPAYMENTS.

(a) GENERAL RULE.—Subparagraph (B) of section 6621(c)(2) (defining applicable date) is amended by adding at the end the following new clause:

> "(iii) EXCEPTION FOR LETTERS OR NOTICES INVOLVING SMALL AMOUNTS.—For purposes of this paragraph, any letter or notice shall be disregarded if the amount of the deficiency or proposed deficiency (or the assessment or proposed assessment) set forth in such letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply for purposes of determining interest for periods after December 31, 1997.

TITLE XV—TECHNICAL AMENDMENTS RELATED TO SMALL BUSINESS JOB PROTECTION ACT OF 1996 AND OTHER LEGISLATION

SEC. 1501. AMENDMENTS RELATED TO SMALL BUSINESS JOB PROTECTION ACT OF 1996.

(a) AMENDMENTS RELATED TO SUBTITLE A.—

(1) AMENDMENT RELATED TO SECTION 1116.—Paragraph (1) of section 6050R(c) is amended by striking "name and address" and inserting "name, address, and phone number of the information contact".

(2) AMENDMENT TO SECTION 1116.—Paragraphs (1) and (2)(C) of section 1116(b) of the Small Business Job Protection Act of

1996 shall each be applied as if the reference to chapter 68 were a reference to chapter 61.

(b) AMENDMENT RELATED TO SUBTITLE B.—Subsection (c) of section 52 is amended by striking "targeted jobs credit" and inserting "work opportunity credit".

(c) AMENDMENTS RELATED TO SUBTITLE C.—

(1) AMENDMENT RELATED TO SECTION 1302.—Subparagraph (B) of section 1361(e)(1) is amended by striking "and" at the end of clause (i), striking the period at the end of clause (ii) and inserting ", and", and adding at the end the following new clause:

"(iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d))."

(2) EFFECTIVE DATE FOR SECTION 1307.—

(A) Notwithstanding section 1317 of the Small Business Job Protection Act of 1996, the amendments made by subsections (a) and (b) of section 1307 of such Act shall apply to determinations made after December 31, 1996.

(B) In no event shall the 120-day period referred to in section 1377(b)(1)(B) of the Internal Revenue Code of 1986 (as added by such section 1307) expire before the end of the 120-day period beginning on the date of the enactment of this Act.

(3) AMENDMENT RELATED TO SECTION 1308.—Subparagraph (A) of section 1361(b)(3) is amended by striking "For purposes of this title" and inserting "Except as provided in regulations prescribed by the Secretary, for purposes of this title".

(4) AMENDMENTS RELATED TO SECTION 1316.—

(A) Paragraph (2) of section 512(e) is amended by striking "within the meaning of section 1012" and inserting "as defined in section 1361(e)(1)(C)".

(B) Paragraph (7) of section 1361(c) is redesignated as paragraph (6).

(C) Subparagraph (B) of section 1361(b)(1) is amended by striking "subsection (c)(7)" and inserting "subsection (c)(6)".

(D) Paragraph (1) of section 512(e) is amended by striking "section 1361(c)(7)" and inserting "section 1361(e)(6)".

(d) AMENDMENTS RELATED TO SUBTITLE D.—

(1) AMENDMENTS RELATED TO SECTION 1421.—

(A) Subsection (i) of section 408 is amended in the last sentence by striking "30 days" and inserting "31 days".

(B) Subparagraph (H) of section 408(k)(6) is amended by striking "if the terms of such pension" and inserting "of an employer if the terms of simplified employee pensions of such employer".

(C)(i) Subparagraph (B) of section 408(l)(2) is amended—

(I) by inserting "and the issuer of an annuity established under such an arrangement" after "under subsection (p)", and

(II) in clause (i), by inserting "or issuer" after "trustee".

(ii) Paragraph (2) of section 6693(c) is amended—

(I) by inserting “or issuer” after “trustee”, and

(II) in the heading, by inserting “AND ISSUER” after “trustee”.

(D) Subsection (p) of section 408 is amended by adding at the end the following new paragraph:

“(8) COORDINATION WITH MAXIMUM LIMITATION UNDER SUBSECTION (a).—In the case of any simple retirement account, subsections (a)(1) and (b)(2) shall be applied by substituting ‘the sum of the dollar amount in effect under paragraph (2)(A)(ii) of this subsection and the employer contribution required under subparagraph (A)(iii) or (B)(i) of paragraph (2) of this subsection, whichever is applicable’ for ‘$2,000’.”

(E) Clause (i) of section 408(p)(2)(D) is amended by adding at the end the following new sentence: “If only individuals other than employees described in subparagraph (A) or (B) of section 410(b)(3) are eligible to participate in such arrangement, then the preceding sentence shall be applied without regard to any qualified plan in which only employees so described are eligible to participate.”

(F) Subparagraph (D) of section 408(p)(2) is amended by adding at the end the following new clause:

“(iii) GRACE PERIOD.—In the case of an employer who establishes and maintains a plan under this subsection for 1 or more years and who fails to meet the requirements of this subparagraph for any subsequent year due to any acquisition, disposition, or similar transaction involving another such employer, rules similar to the rules of section 410(b)(6)(C) shall apply for purposes of this subparagraph.”

(G) Paragraph (5) of section 408(p) is amended in the text preceding subparagraph (A) by striking “simplified” and inserting “simple”.

(2) AMENDMENTS RELATED TO SECTION 1422.—

(A) Clause (ii) of section 401(k)(11)(D) is amended by striking the period and inserting “if such plan allows only contributions required under this paragraph.”

(B) Paragraph (11) of section 401(k) is amended by adding at the end the following new subparagraph:

“(E) COST-OF-LIVING ADJUSTMENT.—The Secretary shall adjust the $6,000 amount under subparagraph (B)(i)(I) at the same time and in the same manner as under section 408(p)(2)(E).”

(C) Subparagraph (A) of section 404(a)(3) is amended—

(i) in clause (i), by striking “not in excess of” and all that follows and inserting the following: “not in excess of the greater of—

“(I) 15 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the stock bonus or profit-sharing plan, or

“(II) the amount such employer is required to contribute to such trust under section 401(k)(11) for such year.”, and

(ii) in clause (ii), by striking "15 percent" and all that follows and inserting the following "the amount described in subclause (I) or (II) of clause (i), whichever is greater, with respect to such taxable year."

(D) Subparagraph (B) of section 401(k)(11) is amended by adding at the end the following new clause:

"(iii) ADMINISTRATIVE REQUIREMENTS.—

"(I) IN GENERAL.—Rules similar to the rules of subparagraphs (B) and (C) of section 408(p)(5) shall apply for purposes of this subparagraph.

"(II) NOTICE OF ELECTION PERIOD.—The requirements of this subparagraph shall not be treated as met with respect to any year unless the employer notifies each employee eligible to participate, within a reasonable period of time before the 60th day before the beginning of such year (and, for the first year the employee is so eligible, the 60th day before the first day such employee is so eligible), of the rules similar to the rules of section 408(p)(5)(C) which apply by reason of subclause (I)."

(3) AMENDMENT RELATED TO SECTION 1433.—The heading of paragraph (11) of section 401(m) is amended by striking "ALTERNATIVE" and inserting "ADDITIONAL ALTERNATIVE".

(4) AMENDMENT RELATED TO SECTION 1462.—The paragraph (7) of section 414(q) added by section 1462 of the Small Business Job Protection Act of 1996 is redesignated as paragraph (9).

(5) CLARIFICATION OF SECTION 1450.—

(A) Section 403(b)(11) of the Internal Revenue Code of 1986 shall not apply with respect to a distribution from a contract described in section 1450(b)(1) of such Act to the extent that such distribution is not includible in income by reason of section 403(b)(8) of such Code (determined after the application of section 1450(b)(2) of such Act).

(B) This paragraph shall apply as if included in section 1450 of the Small Business Job Protection Act of 1996.

(e) AMENDMENT RELATED TO SUBTITLE E.—Subparagraph (A) of section 956(b)(1) is amended by inserting "to the extent such amount was accumulated in prior taxable years" after "section 316(a)(1)".

(f) AMENDMENTS RELATED TO SUBTITLE F.—

(1) AMENDMENTS RELATED TO SECTION 1601.—

(A) The heading of section 30A is amended to read as follows:

"SEC. 30A. PUERTO RICO ECONOMIC ACTIVITY CREDIT."

(B) The table of sections for subpart B of part IV of subchapter A of chapter 1 is amended in the item relating to section 30A by striking "Puerto Rican" and inserting "Puerto Rico".

(C) Paragraph (1) of section 55(c) is amended by striking "Puerto Rican" and inserting "Puerto Rico".

(2) AMENDMENTS RELATED TO SECTION 1606.—

(A) Clause (ii) of section 9503(c)(2)(A) is amended by striking "(or with respect to qualified diesel-powered highway vehicles purchased before January 1, 1999)".

(B) Subparagraph (A) of section 9503(e)(5) is amended by striking "; except that" and all that follows and inserting a period.

(3) AMENDMENTS RELATED TO SECTION 1607.—

(A) Subsection (f) of section 4001 (relating to phasedown of tax on luxury passenger automobiles) is amended—

(i) by inserting "and section 4003(a)" after "subsection (a)", and

(ii) by inserting ", each place it appears," before "the percentage".

(B) Subsection (g) of section 4001 (relating to termination) is amended by striking "tax imposed by this section" and inserting "taxes imposed by this section and section 4003" and by striking "or use" and inserting ", use, or installation".

(4) AMENDMENTS RELATED TO SECTION 1609.—

(A) Subsection (l) of section 4041 is amended—

(i) by inserting "or a fixed-wing aircraft" after "helicopter", and

(ii) in the heading, by striking "HELICOPTER".

(B) The last sentence of section 4041(a)(2) is amended by striking "section 4081(a)(2)(A)" and inserting "section 4081(a)(2)(A)(i)".

(C) Subsection (b) of section 4092 is amended by striking "section 4041(c)(4)" and inserting "section 4041(c)(2)".

(D) Subsection (g) of section 4261 (as redesignated by title X) is amended by inserting "on that flight" after "dedicated".

(E) Paragraph (1) of section 1609(h) of such Act is amended by striking "paragraph (3)(A)(i)" and inserting "paragraph (3)(A)".

(F) Paragraph (4) of section 1609(h) of such Act is amended by inserting before the period "or exclusively for the use described in section 4092(b) of such Code".

(5) AMENDMENTS RELATED TO SECTION 1616.—

(A) Subparagraph (A) of section 593(e)(1) is amended by inserting "(and, in the case of an S corporation, the accumulated adjustments account, as defined in section 1368(e)(1))" after "1951,".

(B) Paragraph (7) of section 1374(d) is amended by adding at the end the following new sentence: "For purposes of applying this section to any amount includible in income by reason of section 593(e), the preceding sentence shall be applied without regard to the phrase '10-year'."

(6) AMENDMENTS RELATED TO SECTION 1621.—

(A) Subparagraph (A) of section 860L(b)(1) is amended in the text preceding clause (i) by striking "after the startup date" and inserting "on or after the startup date".

(B) Paragraph (2) of section 860L(d) is amended by striking "section 860I(c)(2)" and inserting "section 860I(b)(2)".

(C) Subparagraph (B) of section 860L(e)(2) is amended by inserting "other than foreclosure property" after "any permitted asset".

(D) Subparagraph (A) of section 860L(e)(3) is amended by striking "if the FASIT" and all that follows and inserting the following new flush text after clause (ii):

"if the FASIT were treated as a REMIC and permitted assets (other than cash or cash equivalents) were treated as qualified mortgages."

(E)(i) Paragraph (3) of section 860L(e) is amended by adding at the end the following new subparagraph:

"(D) INCOME FROM DISPOSITIONS OF FORMER HEDGE ASSETS.—Paragraph (2)(A) shall not apply to income derived from the disposition of—

"(i) an asset which was described in subsection (c)(1)(D) when first acquired by the FASIT but on the date of such disposition was no longer described in subsection (c)(1)(D)(ii), or

"(ii) a contract right to acquire an asset described in clause (i)."

(ii) Subparagraph (A) of section 860L(e)(2) is amended by inserting "except as provided in paragraph (3)," before "the receipt".

(g) AMENDMENTS RELATED TO SUBTITLE G.—

(1) EXTENSION OF PERIOD FOR CLAIMING REFUNDS FOR ALCOHOL FUELS.—Notwithstanding section 6427(i)(3)(C) of the Internal Revenue Code of 1986, a claim filed under section 6427(f) of such Code for any period after September 30, 1995, and before October 1, 1996, shall be treated as timely filed if filed before the 60th day after the date of the enactment of this Act.

(2) AMENDMENTS TO SECTIONS 1703 AND 1704.—Sections 1703(n)(8) and 1704(j)(4)(B) of the Small Business Job Protection Act of 1996 shall each be applied as if such sections referred to section 1702 instead of section 1602.

(h) AMENDMENTS RELATED TO SUBTITLE H.—

(1) AMENDMENTS RELATED TO SECTION 1806.—

(A) Subparagraph (B) of section 529(e)(1) is amended by striking "subsection (c)(2)(C)" and inserting "subsection (c)(3)(C)".

(B) Subparagraph (C) of section 529(e)(1) is amended by inserting "(or agency or instrumentality thereof)" after "local government".

(C) Paragraph (2) of section 1806(c) of the Small Business Job Protection Act of 1996 is amended by striking so much of the first sentence as follows subparagraph (B)(ii) and inserting the following:

"then such program (as in effect on August 20, 1996) shall be treated as a qualified State tuition program with respect to contributions (and earnings allocable thereto) pursuant to contracts entered into under such program before the first date on which such program meets such requirements (determined without regard to this paragraph) and the provisions of such program (as so in effect) shall apply in lieu of section 529(b) of the Internal Revenue Code of 1986 with respect to such contributions and earnings."

(2) AMENDMENTS RELATED TO SECTION 1807.—

(A) Paragraph (2) of section 23(a) is amended to read as follows:

"(2) YEAR CREDIT ALLOWED.—The credit under paragraph (1) with respect to any expense shall be allowed—

"(A) in the case of any expense paid or incurred before the taxable year in which such adoption becomes final, for the taxable year following the taxable year during which such expense is paid or incurred, and

"(B) in the case of an expense paid or incurred during or after the taxable year in which such adoption becomes final, for the taxable year in which such expense is paid or incurred."

(B) Subparagraph (B) of section 23(b)(2) is amended by striking "determined—" and all that follows and inserting the following: "determined without regard to sections 911, 931, and 933."

(C) Paragraph (1) of section 137(b) (relating to adoption assistance programs) is amended by striking "amount excludable from gross income" and inserting "of the amounts paid or expenses incurred which may be taken into account".

(D)(i) Subparagraph (C) of section 414(n)(3) is amended by inserting "137," after "132,".

(ii) Paragraph (2) of section 414(t) is amended by inserting "137," after "132,".

(iii) Paragraph (1) of section 6039D(d) is amended by striking "or 129" and inserting "129, or 137".

(i) AMENDMENTS RELATED TO SUBTITLE I.—

(1) AMENDMENT RELATED TO SECTION 1901.—Subsection (b) of section 6048 is amended in the heading by striking "GRANTOR" and inserting "OWNER".

(2) AMENDMENTS RELATED TO SECTION 1903.—

Clauses (ii) and (iii) of section 679(a)(3)(C) are each amended by inserting ", owner," after "grantor".

(3) AMENDMENTS RELATED TO SECTION 1907.—

(A) Clause (ii) of section 7701(a)(30)(E) is amended by striking "fiduciaries" and inserting "persons".

(B) Subsection (b) of section 641 is amended by adding at the end the following new sentence: "For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time."

(4) EFFECTIVE DATE RELATED TO SUBTITLE I.—The Secretary of the Treasury may by regulations or other administrative guidance provide that the amendments made by section 1907(a) of the Small Business Job Protection Act of 1996 shall not apply to a trust with respect to a reasonable period beginning on the date of the enactment of such Act, if—

(A) such trust is in existence on August 20, 1996, and is a United States person for purposes of the Internal Revenue Code of 1986 on such date (determined without regard to such amendments),

(B) no election is in effect under section 1907(a)(3)(B) of such Act with respect to such trust,

(C) before the expiration of such reasonable period, such trust makes the modifications necessary to be treated as a United States person for purposes of such Code (determined with regard to such amendments), and

(D) such trust meets such other conditions as the Secretary may require.

(j) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall take effect as if included in the provisions of the Small Business Job Protection Act of 1996 to which they relate.

(2) CERTAIN ADMINISTRATIVE REQUIREMENTS WITH RESPECT TO CERTAIN PENSION PLANS.—The amendment made by subsection (d)(2)(D) shall apply to calendar years beginning after the date of the enactment of this Act.

SEC. 1502. AMENDMENTS RELATED TO HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996.

(a) AMENDMENTS RELATED TO SECTION 301.—

(1) Paragraph (2) of section 26(b) is amended by striking "and" at the end of subparagraph (N), by striking the period at the end of subparagraph (O) and inserting ", and", and by adding at the end the following new subparagraph:

"(P) section 220(f)(4) (relating to additional tax on medical savings account distributions not used for qualified medical expenses)."

(2) Paragraph (3) of section 220(c) is amended by striking subparagraph (A) and redesignating subparagraphs (B) through (D) as subparagraphs (A) through (C), respectively.

(3) Subparagraph (C) of section 220(d)(2) is amended by striking "an eligible individual" and inserting "described in clauses (i) and (ii) of subsection (c)(1)(A)".

(4) Subsection (a) of section 6693 is amended by adding at the end the following new sentence:

"This subsection shall not apply to any report which is an information return described in section 6724(d)(1)(C)(i) or a payee statement described in section 6724(d)(2)(X)."

(5) Paragraph (4) of section 4975(d) is amended by striking "if, with respect to such transaction" and all that follows and inserting the following: "if section 220(e)(2) applies to such transaction."

(b) AMENDMENT RELATED TO SECTION 321.—Subparagraph (B) of section 7702B(c)(2) is amended in the last sentence by inserting "described in subparagraph (A)(i)" after "chronically ill individual".

(c) AMENDMENT RELATED TO SECTION 322.—Subparagraph (B) of section 162(l)(2) is amended by adding at the end the following new sentence: "The preceding sentence shall be applied separately with respect to—

"(i) plans which include coverage for qualified long-term care services (as defined in section 7702B(c)) or are qualified long-term care insurance contracts (as defined in section 7702B(b)), and

"(ii) plans which do not include such coverage and are not such contracts."

(d) AMENDMENTS RELATED TO SECTION 323.—

(1) Paragraph (1) of section 6050Q(b) is amended by inserting ", address, and phone number of the information contact" after "name".

(2)(A) Paragraph (2) of section 6724(d) is amended by striking so much as follows subparagraph (Q) and precedes the last sentence, and inserting the following new subparagraphs:

"(R) section 6050R(c) (relating to returns relating to certain purchases of fish),

"(S) section 6051 (relating to receipts for employees),

"(T) section 6052(b) (relating to returns regarding payment of wages in the form of group-term life insurance),

"(U) section 6053(b) or (c) (relating to reports of tips),

"(V) section 6048(b)(1)(B) (relating to foreign trust reporting requirements),

"(W) section 4093(c)(4)(B) (relating to certain purchasers of diesel and aviation fuels),

"(X) section 408(i) (relating to reports with respect to individual retirement plans) to any person other than the Secretary with respect to the amount of payments made to such person, or

"(Y) section 6047(d) (relating to reports by plan administrators) to any person other than the Secretary with respect to the amount of payments made to such person."

(B) Subsection (e) of section 6652 is amended in the last sentence by striking "section 6724(d)(2)(X)" and inserting "section 6724(d)(2)(Y)".

(e) AMENDMENT RELATED TO SECTION 325.—Clauses (ii) and (iii) of section 7702B(g)(4)(B) are each amended by striking "Secretary" and inserting "appropriate State regulatory agency".

(f) AMENDMENTS RELATED TO SECTION 501.—

(1) Paragraph (4) of section 264(a) is amended by striking subparagraph (A) and all that follows through "by the taxpayer." and inserting the following:

"(A) is or was an officer or employee, or

"(B) is or was financially interested in,

any trade or business carried on (currently or formerly) by the taxpayer."

(2) The last 2 sentences of section 264(d)(2)(B)(ii) are amended to read as follows:

"For purposes of subclause (II), the term 'applicable period' means the 12-month period beginning on the date the policy is issued (and each successive 12-month period thereafter) unless the taxpayer elects a number of months (not greater than 12) other than such 12-month period to be its applicable period. Such an election shall be made not later than the 90th day after the date of the enactment of this sentence and, if made, shall apply to the taxpayer's first taxable year ending on or after October 13, 1995, and all subsequent taxable years unless revoked with the consent of the Secretary."

(3) Subparagraph (B) of section 264(d)(4) is amended by striking "the employer" and inserting "the taxpayer".

(4) Subsection (c) of section 501 of the Health Insurance Portability and Accountability Act of 1996 is amended by striking paragraph (3).

(5) Paragraph (2) of section 501(d) of such Act is amended by striking "no additional premiums" and all that follows and inserting the following: "a lapse occurring by reason of no additional premiums being received under the contract after October 13, 1995."

(g) AMENDMENTS RELATED TO SECTION 511.—

(1) Subparagraph (B) of section 877(d)(2) is amended by striking "the 10-year period described in subsection (a)" and inserting "the 10-year period beginning on the date the individual loses United States citizenship".

(2) Subparagraph (D) of section 877(d)(2) is amended by adding at the end the following new sentence: "In the case of any exchange occurring during such 5 years, any gain recognized under this subparagraph shall be recognized immediately after such loss of citizenship."

(3) Paragraph (3) of section 877(d) is amended by inserting "and the period applicable under paragraph (2)" after "subsection (a)".

(4) Subparagraph (A) of section 877(d)(4) is amended—

(A) by inserting "during the 10-year period beginning on the date the individual loses United States citizenship" after "contributes property" in clause (i),

(B) by inserting "immediately before such contribution" after "from such property", and

(C) by striking "during the 10-year period referred to in subsection (a),".

(5) Subparagraph (C) of section 2501(a)(3) is amended by striking "decedent" and inserting "donor".

(6)(A) Clause (i) of section 2107(c)(2)(A) is amended by striking "such foreign country in respect of property included in the gross estate" and inserting "such foreign country".

(B) Subparagraph (C) of section 2107(c)(2) is amended to read as follows:

"(C) PROPORTIONATE SHARE.—In the case of property which is included in the gross estate solely by reason of subsection (b), such property's proportionate share is the percentage which the value of such property bears to the total value of all property included in the gross estate solely by reason of subsection (b).".

(h) AMENDMENTS RELATED TO SECTION 512.—

(1) Subpart A of part III of subchapter A of chapter 61 is amended by redesignating the section 6039F added by section 512 of the Health Insurance Portability and Accountability Act of 1996 as section 6039G and by moving such section 6039G to immediately after the section 6039F added by section 1905 of the Small Business Job Protection Act of 1996.

(2) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking the item relating to the section 6039F related to information on individuals losing United States citizenship and inserting after the item relating to the section 6039F related to notice of large gifts received from foreign persons the following new item:

"Sec. 6039G. Information on individuals losing United States citizenship."

(3) Paragraph (1) of section 877(e) is amended by striking "6039F" and inserting "6039G".

(i) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the provisions of the Health Insurance Portability and Accountability Act of 1996 to which such amendments relate.

SEC. 1503. AMENDMENTS RELATED TO TAXPAYER BILL OF RIGHTS 2.

(a) AMENDMENT RELATED TO SECTION 1311.—Subsection (b) of section 4962 is amended by striking "subchapter A or C" and inserting "subchapter A, C, or D".

(b) AMENDMENTS RELATED TO SECTION 1312.—

(1)(A) Paragraph (10) of section 6033(b) is amended by striking all that precedes subparagraph (A) and inserting the following:

"(10) the respective amounts (if any) of the taxes imposed on the organization, or any organization manager of the organization, during the taxable year under any of the following provisions (and the respective amounts (if any) of reimbursements paid by the organization during the taxable year with respect to taxes imposed on any such organization manager under any of such provisions):".

(B) Subparagraph (C) of section 6033(b)(10) is amended by adding at the end the following: "except to the extent that, by reason of section 4962, the taxes imposed under such section are not required to be paid or are credited or refunded,".

(2) Paragraph (11) of section 6033(b) is amended to read as follows:

"(11) the respective amounts (if any) of—

"(A) the taxes imposed with respect to the organization on any organization manager, or any disqualified person, during the taxable year under section 4958 (relating to taxes on private excess benefit from certain charitable organizations), and

"(B) reimbursements paid by the organization during the taxable year with respect to taxes imposed under such section,

except to the extent that, by reason of section 4962, the taxes imposed under such section are not required to be paid or are credited or refunded,".

(c) EFFECTIVE DATE.—The amendments made by this section shall take effect as if included in the provisions of the Taxpayer Bill of Rights 2 to which such amendments relate.

SEC. 1504. MISCELLANEOUS PROVISIONS.

(a) AMENDMENTS RELATED TO ENERGY POLICY ACT OF 1992.—

(1) Paragraph (1) of section 263(a) is amended by striking "or" at the end of subparagraph (F), by striking the period at the end of subparagraph (G) and inserting "; or", and by adding at the end the following new subparagraph:

"(H) expenditures for which a deduction is allowed under section 179A."

(2) Subparagraph (B) of section 312(k)(3) is amended—

(A) by striking "179" in the heading and the first place it appears in the text and inserting "179 or 179A", and

(B) by striking "179" the last place it appears and inserting "179 or 179A, as the case may be".

(3) Paragraphs (2)(C) and (3)(C) of section 1245(a) are each amended by inserting "179A," after "179,".

(4) The amendments made by this subsection shall take effect as if included in the amendments made by section 1913 of the Energy Policy Act of 1992.

(b) AMENDMENTS RELATED TO URUGUAY ROUND AGREEMENTS ACT.—

(1) Paragraph (1) of section 6621(a) is amended in the last sentence by striking "subsection (c)(3))" and inserting "subsection (c)(3), applied by substituting 'overpayment' for 'underpayment')".

(2) Subclause (II) of section 412(m)(5)(E)(ii) is amended by striking "clause (i)" and inserting "subclause (I)".

(3) Subparagraph (A) of section 767(d)(3) of the Uruguay Round Agreements Act is amended in the last sentence by striking "(except that" and all that follows through "into account)".

(4) The amendments made by this subsection shall take effect as if included in the sections of the Uruguay Round Agreements Act to which they relate.

(c) AMENDMENT RELATED TO OMNIBUS BUDGET RECONCILIATION ACT OF 1993.—

(1) Paragraph (6) of section 168(j) (defining Indian reservation) is amended by adding at the end the following new flush sentence:

"For purposes of the preceding sentence, such section 3(d) shall be applied by treating the term 'former Indian reservations in Oklahoma' as including only lands which are within the jurisdictional area of an Oklahoma Indian tribe (as determined by the Secretary of the Interior) and are recognized by such Secretary as eligible for trust land status under 25 CFR Part 151 (as in effect on the date of the enactment of this sentence)."

(2) The amendment made by paragraph (1) shall apply as if included in the amendments made by section 13321 of the Omnibus Budget Reconciliation Act of 1993, except that such amendment shall not apply—

(A) with respect to property (with an applicable recovery period under section 168(j) of the Internal Revenue Code of 1986 of 6 years or less) held by the taxpayer if the taxpayer claimed the benefits of section 168(j) of such Code with respect to such property on a return filed before March 18, 1997, but only if such return is the first return of tax filed for the taxable year in which such property was placed in service, or

(B) with respect to wages for which the taxpayer claimed the benefits of section 45A of such Code for a taxable year on a return filed before March 18, 1997, but only if such return was the first return of tax filed for such taxable year.

(d) AMENDMENT RELATED TO TAX REFORM ACT OF 1986.—Paragraph (3) of section 1059(d) is amended by striking "subsection (a)(2)" and inserting "subsection (a)".

(e) AMENDMENT RELATED TO TAX REFORM ACT OF 1984.—

(1) Section 267(f) is amended by adding at the end the following new paragraph:

"(4) DETERMINATION OF RELATIONSHIP RESULTING IN DISALLOWANCE OF LOSS, FOR PURPOSES OF OTHER PROVISIONS.—For purposes of any other section of this title which refers to a relationship which would result in a disallowance of losses under this section, deferral under paragraph (2) shall be treated as disallowance."

(2) EFFECTIVE DATE.—The amendment made by paragraph (1) shall take effect as if included in section 174(b) of the Tax Reform Act of 1984.

(f) CLERICAL AMENDMENTS.—

(1) Clause (iii) of section 163(j)(2)(B) is amended by striking "clause (i)" and inserting "clause (ii)".

(2) Paragraph (1) of section 665(d) is amended in the last sentence by striking "or 669(d) and (e)".

(3) Subsection (g) of section 1441 (relating to cross reference) is amended by striking "one-half" and inserting "85 percent".

(4) Paragraph (1) of section 2523(g) is amended by striking "qualified remainder trust" and inserting "qualified charitable remainder trust".

(5) Subsection (d) of section 9502 is amended by redesignating the paragraph added by section 806 of the Federal Aviation Reauthorization Act of 1996 as paragraph (6).

STATEMENT OF THE HOUSE COMMITTEE ON THE BUDGET

ON THE REVENUE RECONCILIATION ACT OF 1997

To serve the American people, balancing the Federal budget is only half the job. Congress and the administration must, at the same time, let Americans keep more of their own money—to save, to invest, and to make their own choices about how best to use the resources they have earned.

That is the principle behind this legislation, the Revenue Reconciliation Act of 1997. This bill and its twin measure, the Balanced Budget Act of 1997, seek jointly to fulfill the reconciliation directives of the Concurrent Resolution on the Budget for Fiscal Year 1997. That resolution embraced the Bipartisan Budget Agreement, between the Congressional leadership and the administration, to balance the Federal budget by 2002 and provide much-needed tax relief for America's middle-income working families.

Key components of this tax package include the following:

- A total of $85 billion in net tax relief over the next 5 years and $250 billion over the next 10 years.
- A tax credit, reaching $500 per child, that will benefit 41 million children of America's families.
- Roughly $35 billion over 5 years in post-secondary education tax incentives.
- Broad-based relief from capital gains taxes to promote capital formation and, most important, job creation.
- Expansion of individual retirement accounts [IRA's] to encourage personal saving.
- Significant reductions in death taxes.
- Reform of corporate taxes through the repeal of roughly $14 billion over 5 years in inappropriate corporate tax benefits.

This tax package represents a good faith effort to meet the terms of the Bipartisan Budget Agreement. Most important, though, it meets the needs of American taxpayers. It also proceeds from an unalterable truth: the people who know best how to spend their money are the people themselves.

COMMITTEE ON WAYS AND MEANS,
HOUSE OF REPRESENTATIVES,
Washington, DC, June 14, 1997.

Hon. JOHN R. KASICH,
Chairman, Committee on the Budget, Washington, DC.

DEAR MR. CHAIRMAN: On June 13, 1997, the Committee on Ways and Means, pursuant to H. Con. Res. 84, the Concurrent Resolution on the Budget for Fiscal Year 1998, ordered favorably reported, as amended, its budget reconciliation revenue recommendations, to the Committee on Budget by a recorded vote of 22–16. Accordingly, I am now transmitting these recommendations to you.

Enclosed are the legislative language, explanatory report language, estimates of the Congressional Budget Office and the Joint Committee on Taxation.

Please feel free to contact me or Pete Singleton if you have any questions. With best personal regards,

Sincerely,

BILL ARCHER,
Chairman.

Enclosures.

I. INTRODUCTION

A. PURPOSE AND SUMMARY

Purpose

The revenue reconciliation provisions included in the Committee's budget reconciliation recommendations provide income and estate and gift tax relief to America's families, educational tax benefits, savings and investment incentives, estate and gift tax relief to closely-held businesses, extension of certain expiring tax provisions, District of Columbia tax incentives, welfare-to-work tax credit, various miscellaneous tax provisions, revenue-offset provisions (including a 10-year extension of financing of the Airport and Airway Trust Fund and corporate and other tax reforms), numerous tax simplification provisions (most of which have been previously approved by the Committee and the Congress in the Balanced Budget Act of 1995 in the 104th Congress, but not enacted), needed technical corrections to recently-passed tax legislation, and an increase in the public debt limit as projected under the Balanced Budget Agreement and the Fiscal Year 1998 Budget Resolution.

Summary

The following is a brief summary of the revenue reconciliation provisions of the bill.

Title I—Child and Dependent Care Tax Credits; Health Care for Children

Child tax credit for children under the age of 17—The bill allows taxpayers a maximum nonrefundable tax credit of $500 ($400 for taxable year 1998) for each qualifying child under the age of 17. For taxpayers with modified AGI in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit is phased out. Beginning after 2001, the otherwise allowable child credit is reduced by one-half of the amount of the taxpayer's dependent care credit. Generally, the child tax credit is effective for taxable years beginning after December 31, 1997.

Dependent care credit—The present-law credit is indexed for inflation. The credit is also phased out in conjunction with the child tax credit for high-income taxpayers. The provision is effective for taxable years beginning after December 31, 1997.

Expand definition of high-risk individuals with respect to tax-exempt State-sponsored organizations providing health coverage—The bill 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 provision is effective for taxable years beginning after December 31, 1997.

Title II—Education Tax Incentives

HOPE credit for higher education tuition expenses—Individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per student for 50 percent of qualified tuition and related expenses (i.e., tuition, fees, and books but not room and board) paid for the first two years of post-secondary education for the taxpayer, the taxpayer's spouse, or a dependent. The credit is phased out for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Eligible students must be enrolled on at least a half-time basis at a college, university, or certain vocational schools, but need not maintain any specific grade point average. The credit is not available with respect to a student if a taxpayer elects to claim the proposed deduction for qualified higher education expenses (described below) with respect to that student for the taxable year. The provision is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

Deduction for qualified higher education expenses and tax treatment of qualified tuition programs and education investment accounts—Individual taxpayers are allowed a deduction of up to $10,000 per student per year for qualified higher education expenses (i.e., tuition, fees, books, supplies, and room and board) paid by the taxpayer during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, or a dependent. The deduction is allowed only to the extent that the taxpayer is required to include in gross income for the taxable year earnings distributed from a qualified tuition program (which is a tax-exempt prepaid tuition program maintained by a State or one or more private colleges) or an education investment account (which is a tax-exempt trust established exclusively for the purpose of paying qualified higher education expenses of the account holder). The deduction is allowed regardless of whether or not the taxpayer otherwise itemizes deductions or claims the standard deduction. The deduction is not available, however, with respect to a student if the proposed HOPE credit (described above) is claimed with respect to that student for the taxable year. Aggregate deductions allowed for a student for all taxable years are limited to $40,000. The deduction is not available for graduate-level courses. Contributions to education investment accounts and qualified tuition programs not operated by a State may not exceed $5,000 per beneficiary per year (with an aggregate contribution limit of $50,000 per beneficiary for all years). The deduction is available for qualified higher education expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

Phase out qualified tuition reduction exclusion—The bill phases out the special rule in section 117(d) that excludes a qualified tuition reduction provided to an employee of an educational organization from gross income. The excludable percentage is 80 percent in 1998 and is reduced by 20 percent each year thereafter; no exclusion is permitted after 2001.

Penalty free IRA withdrawals for education expenses—The bill provides that individuals may make penalty-free withdrawals from their IRAs to pay for the undergraduate and graduate higher education expenses of themselves, their spouses, their children and grandchildren or the children or grandchildren of their spouses.

Tax credit for certain tutoring expenses—The bill provides a nonrefundable tax credit equal to the lesser of (1) $150 or (2) 50 percent of the costs of supplementary educational assistance provided to elementary or secondary school students. The credit is phased out for taxpayers with adjusted gross income in excess of certain limits The credit is available for taxable years beginning after December 31, 1997.

Exclusion for employer-provided educational assistance—The bill extends the exclusion for employer-provided educational assistance to courses beginning before January 1, 1998.

Modification of $150 million limit on qualified 510(c)(3) non-hospital bonds—The $150 million limit is increased annually in $10 million increments until it reaches $200 million.

Enhanced deduction for corporate contributions of computer technology and equipment—The bill provides that corporate contributions of computer technology and equipment to be used for educational purposes in any of grades K–12 qualifies for the augmented contribution deduction currently available under Code sections 170(e)(3) and 170(e)(4). The provision is effective for contributions made in taxable years beginning after 1997.

Treatment of cancellation of certain student loans—The bill expands present-law section 108(f) so that an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations provided the loan recipient's work satisfies a community benefit requirement. Section 108(f) also is expanded to cover forgiveness of certain Federal direct student loans for which an income-contingent repayment option has been selected.

Title III—Savings and Investment Tax Incentives

American Dream IRAs—The bill replaces present-law nondeductible IRAs with new American Dream IRAs ("AD IRAs") to which all individuals may make nondeductible contributions of up to $2,000 annually. Contributions to an AD IRA are in addition to any contributions that can be made to a deductible IRA under the present-law rules. No income limitations apply to AD IRAs. Withdrawals from an AD IRA are not includible in income if the withdrawal (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to an AD IRA, and (2) 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) for first-time homebuyer expenses.

Capital gains provisions—The bill reduces the maximum rate of capital gains of individuals from 28 percent to 20 percent (10 percent for gains otherwise taxed at the 15-percent rate), effective May 7, 1997. This maximum rate applies both for the regular tax and the alternative minimum tax. A 26-percent maximum rate is provided for gain attributable to real estate depreciation. The maximum rate for gain attributable to collectibles remains at 28 percent. For certain assets acquired after December 31, 2000, and held 3 years or more, the cost basis may be indexed for inflation. The bill generally provides that $250,000 ($500,000 in the case of a married couple) of gain from the sale of a principal residence is exempt from tax, for sales after May 6, 1997. The bill reduces the corporate capital gains tax on assets held more than 8 years to 30 percent (32 percent in 1998 and 31 percent in 1999). The bill modifies the "110 percent of last year's liability" safe harbor of the individual estimated tax to a "109 percent of last year's liability" safe harbor for 1997 estimated tax payments.

Title IV—Alternative Minimum Tax Provisions

Modifications to the alternative minimum tax ("AMT")—The bill (1) increases and indexes (after 2007) the AMT exemption amounts applicable to individuals, (2) repeals the depreciation adjustment for property placed in service after 1998, and (3) repeals the corporate AMT for small business for taxable years beginning after 1997.

Minimum tax installment sales of farmers—The bill repeals the minimum tax on installment sales of farmers, effective for dispositions after 1987.

Title V—Estate and Gift Tax Provisions

Increase in estate and gift tax unified credit—The bill increases the present-law unified credit as follows: the effective exemption is $650,000 for decedents dying and gifts made in 1998; $750,000 in 1999; $765,000 in 2000; $775,000 in 2001 through 2004; $800,000 in 2005; $825,000 in 2006; $1 million in 2007. After 2007, the effective exemption is indexed annually for inflation.

Indexing of certain other estate and gift tax provisions—The bill 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, 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.

Installment payments of estate tax attributable to closely held businesses—The bill extends the period for which Federal estate tax installments can be made under section 6166 to a maximum period of 24 years. In addition, the bill provides that no interest 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). For businesses with a taxable value in excess of $1,000,000, the bill also eliminates the deductibility of interest paid on estate taxes deferred under section 6166, and reduces the interest rate accordingly.

Estate tax recapture from cash leases of specially-valued property—The bill 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).

Clarify eligibility for extension of time for payment of estate tax—The bill gives taxpayers access to the courts to resolve disputes over an estate's eligibility for the section 6166 election by authorizing the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

Gifts may not be revalued for estate tax purposes after expiration of statute of limitations—The bill 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.

Repeal of throwback rules applicable to domestic trusts—The bill exempts from the throwback rules amounts distributed by a domestic trust after December 31, 1995. The provision also provides that precontribution gain on property sold by a domestic trust no longer is subject to section 644.

Unified credit of decedent increased by unified credit of spouse used on split gift included in decedent's gross estate—With respect to any split-gift property that is subsequently includible in both spouses' estates, the bill increases the unified credit allowable to the decedent's estate by the amount of the unified credit previously allowed to the decedent's spouse with respect to the split gift.

Reformation of defective bequests to spouse of decedent—The bill allows the marital deduction with respect to a defective power of appointment or QTIP trust if a reformation (meeting certain criteria) is made to correct the defect.

Generation-skipping tax provisions—The bill provides that if a trust with an inclusion ratio of greater than zero is severed into two separate trusts, the bill allows the trustee to elect to treat one of the separate trusts as having an inclusion ratio of zero and the other separate trust as having an inclusion ratio of one. In addition, the bill 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. The predeceased parent exception (as modified) also is extended to taxable terminations and taxable distributions.

Title VI—Extension of Certain Expiring Tax Provisions

Research tax credit—The research tax credit is extended for the period June 1, 1997, through December 31, 1998 (with a special rule providing a similar, 19-month extension for taxpayers which elect the alternative incremental research credit regime).

Contributions of stock to private foundations—The bill extends the special rule contained in section 170(e)(5) that allows a deduction equal to fair market value for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through December 31, 1998.

Work opportunity tax credit—The bill extends the work opportunity tax credit for one year and makes other modifications. The provisions generally are effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before October 1, 1998.

Orphan drug tax credit—The bill permanently extends the orphan drug tax credit, effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

Title VII—District of Columbia Tax Incentives

D.C. Enterprise Zone—The bill designates certain economically depressed census tracts within the District of Columbia as the "D.C. Enterprise Zone," within which business and individual residents are eligible for special tax incentives. All of the tax incentives take effect only if, prior to January 1, 1998, a Federal law is enacted creating a District of Columbia economic development corporation. In general, tax incentives that are available under present law for certain businesses located in empowerment zones are available in the D.C. Enterprise Zone. These are: (1) a 20-percent wage credit for the first $15,000 of wages paid to D.C. Enterprise Zone 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, the bill provides $75 million in tax credits to be allocated by the newly created economic development corporation to taxpayers that make equity investments in, or loans to, businesses engaged in an active trade or business anywhere in the District of Columbia. The bill also provides a zero percent capital gains rate for capital gains from the sale of certain qualified D.C. Enterprise Zone business assets held for more than 5 years. Finally, the bill provides that residents of the D.C. Enterprise Zone are entitled to a 10-percent tax rate on all taxable income that currently is subject to a 15-percent Federal income tax rate.

Title VIII—Welfare-to-Work Tax Credit

The bill provides employers a credit on the first $20,000 of eligible wages paid to qualified long-term family assistance recipients. Qualified long-term family assistance recipients include members of a family receiving family assistance for specified periods of time and members of family no longer on family assistance because of either Federal or State time limits. The maximum credit is $8,500 per employee. The provision is effective for wages paid or incurred to qualified individuals who begin work for an employer on or after January 1, 1998 and before May 1, 1999.

Title IX—Miscellaneous Provisions

Repeal excise tax on diesel fuel used in recreational boats—The bill repeals the tax on diesel fuel used in recreational boats.

Modify excise tax on ozone-depleting chemicals—The bill repeals the present-law exemption for imported recycled halon-1211.

Modify rate structure of vaccine excise tax—The bill modifies the excise tax on vaccines to provide a uniform rate of tax of $0.84 per dose for all vaccines. In addition, the bill adds the HIB (hemophilus influenza type B) vaccine, the Hepatitis B vaccine, and the varicella (chickenpox) vaccine to the list of taxable vaccines.

Treat certain "chain retailers" as wholesale distributors under the gasoline tax refund rules—Chain retailers, defined as owner-operators having 10 or more retail outlets, are permitted to claim gasoline tax refunds for fuel sold to States and local governments and certain others under the provisions that currently apply to wholesale distributors.

Application of luxury excise tax to clean fuel vehicles—The bill increases the threshold at which the luxury excise tax on automobiles applies in the case of clean-burning fuel vehicles and electric cars.

Provisions relating to pensions and other benefits—The bill (1) provides that certain irrigation or ditch companies or districts may maintain cash or deferred arrangements ("section 401(k) plans"); (2) provides that the current moratorium on the application of certain discrimination rules to State and local government plans is permanent; (3) provides that certain disability payments made on behalf of full-time employees of a police or fire department are excludable from income; (4) provides that contributions made by government employees to purchase certain permissive service credit under a governmental pension plan are not to be taken into account in determining annual additions; (5) provides a deduction from the taxable estate for the value of certain stock transferred to an employee stock ownership plan; (6) increases the maximum benefit that can be distributed from a qualified pension plan without the participant's consent from $3,500 to $5,000 (indexed); (7) clarifies certain rules relating to employee stock ownership plans of S corporations; and (8) provides that the value of certain air transportation on employer-provided noncommercial flights is excludable from income.

Disaster relief provisions—The bill provides the Secretary of the Treasury with the authority to extend additional taxpayer deadlines for up to 90 days for certain taxpayers affected by Presidentially declared disasters. The bill also contains a provision relating to the use of certain appraisals to establish the amount of a disaster loss. In addition, the bill extends the deferral provisions of present law applicable to livestock sold on account of drought to livestock sold on account of floods and other weather-related conditions. Finally, the bill modifies the mortgage revenue bond rules to extend them to Presidentially declared disaster areas. Specifically, the bill waives the first-time homebuyer requirement, the income limits and the purchase price limits during the one-year period following the date of the disaster declaration. The provision is effective for loans financed with bonds issued after December 31, 1996, and before January 1, 2000.

Provisions relating to employment taxes—The bill (1) provides a safe harbor under which, if certain requirements are satisfied, a worker is classified as an independent contractor for Federal tax purposes; (2) removes the statutory rule treating bakery drivers as employees, so that the generally applicable rules for determining worker status apply to bakery drivers; (3) provides that certain instructions of a service recipient provided pursuant to Federal or State law are not taken into account in determining whether a retail securities broker is an employee or independent contractor; and (4) provides that certain termination payments received by former insurance salesmen are not subject to self-employment taxes.

Provisions relating to small businesses—The bill provides for an 18-month delay in the imposition of penalties for specified failures to make payments electronically through EFPTS. In addition, the bill provides that a home office qualifies as the "principal place of business"—such that certain expenses with respect to such office may be deductible as a trade or business expense—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 are allowed for a home office meeting this 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. The provision applies to taxable years beginning after December 31, 1997.

Other provisions—

Inventory shrinkage—The bill 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.

Treatment of workmen's compensation liability under rules for certain personal injury liability assignments—The provision extends the exclusion for qualified assignments under section 130 to amounts assigned for assuming a liability to pay compensation under any workmen's compensation act, effective for workmen's compensation claims filed after the date of enactment.

Treatment of State workmen's compensation funds—The provision 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, and that meets certain additional requirements. The provision is effective for taxable years beginning after December 31, 1997. No inference is intended as to the status of such organizations under present law.

Treatment of certain publicly traded partnerships—In the case of an existing publicly traded partnership that elects under the provision 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. The provision is effective for taxable years beginning after December 31, 1997.

Exclusion from UBIT for certain corporate sponsorship payments—The bill provides that "qualified sponsorship payments" received by tax-exempt organizations are exempt from taxation under the unrelated business income tax ("UBIT"). "Qualified sponsorship payments" are defined as any payment made by a person engaged in a trade or business with respect to which that person receives from the tax-exempt organization 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. The provision applies to qualified sponsorship payments solicited or received after December 31, 1997.

Timeshare associations—The bill generally extends the rules for taxation of homeowners associations to timeshare associations. However, the rate of tax applicable to timeshare associations is 32 percent, rather than 30 percent. The provision is effective for taxable years beginning after December 31, 1996.

Modification of advance refunding rules for certain tax-exempt bonds issued by the Virgin Islands—One additional advance refunding is allowed for governmental bonds issued by the Virgin Islands that were advance refunded before June 9, 1997, if the Virgin Islands debt provisions are changed to modify their lien requirement.

Farm co-ops—The bill provides that gain may be deferred on the sale of refiners and processors to a farm cooperative.

Information reporting on sales of principal residences—Reports to the IRS are not be required for most sales of primary residences with a sales price of $500,000 or less ($250,000 or less if the seller is not married), provided the person settling the sale obtains representations that any gain on the sale is eligible to be excluded.

Increased deduction for certain business meals—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 is increased from 50 percent to 80 percent in stages, over an eleven year period beginning in 1998.

Treatment of construction allowances provided to lessees with respect to short-term leases—The bill provides an exclusion from income for a retail tenant that receives construction allowances from a landlord to the extent the tenant uses the allowances to construct or improve nonresidential real property that reverts to the landlord at the end of a short-term lease.

Mutual savings banks—The provision provides that the consolidation of two or more life insurance departments of mutual savings banks into a single life insurance company by requirement of State law is treated as a recapitalization. Any payments required to be made to policyholders in connection with the consolidation are treated as policyholder dividends deductible by the company under section 808, provided that certain requirements are met. The provision takes effect on December 31, 1991.

Allow refunds to be offset for State tax obligations— Subject to certain limitations, an overpayment of Federal tax could be offset by the amount of any past-due, legally enforceable State tax obligation of a resident of the State seeking the offset.,

Clean fuel vehicles—The bill increases the limitation on depreciation permitted to be claimed by the taxpayer on automobiles in the case of clean-burning fuel vehicles and electric cars.

Tax benefits for law enforcement officers killed in the line of duty—The bill provides that certain death benefits received with respect to a police officer killed in the line of duty are excludable from income.

Two-year suspension of oil and gas income net income limit for production from marginal wells—The bill suspends the 65-percent-of-net-income limitation on percentage depletion deductions for domestic oil and gas production from marginal properties for taxable years beginning in 1998 and 1999.

Extension of duty-free treatment under Generalized System of Preferences; Tariff treatment of certain equipment and repair of vehicles

Generalized System of Preferences—The bill reauthorizes Title V of the Trade Act of 1974, (the Generalized System of Preferences), as amended, for two years through May 31, 1999. Refunds would be authorized, upon request of the importer, for any duty paid between May 31, 1997 and the date of enactment.

Temporary suspension of vessel repair duty (shipbuilding)—The bill suspends, for a one-year period beginning on date of enactment, the current 50-percent duty, established under section 466 of the Tariff Act of 1930, on repairs to U.S. flag vessels made in countries that are signatories to the OECD Shipbuilding Agreement.

United States-Caribbean Basin Trade Partnership Program

The bill amends section 213(b) of the Caribbean Basin Economic Recovery Act to provide tariff and quota treatment on imports from CBI beneficiary countries of currently excluded articles (such as textiles, apparel, tuna, petroleum and petroleum products, and footwear) that is similar to tariff and quota treatment accorded to like articles imported from Mexico under the NAFTA, during a temporary period of one year.

Title X—Revenue-Increase Provisions

Financial Products

Require recognition of gain on certain appreciated positions in financial property—The bill requires a taxpayer with an appreciated position in stock, a partnership interest or certain trust interests or debt instruments to recognize gain as if the taxpayer had sold the position if the taxpayer enters into one of several transactions. The transactions covered are a "short sale against the box", a forward or futures contract to deliver the same property, an offsetting notional principal contract, and, as provided in Treasury regulations, other transactions with substantially the same effect. An exception is provided for certain transactions that are closed prior to the end of the taxable year in which they are entered into, or within 30 days thereafter. The bill also extends the present law "mark-to-market" regime for securities dealers to securities traders and commodities traders and dealers on an elective basis.

Limitation on exception for investment companies under section 351—The bill expands the definition of an investment company for purposes of the present-law rule that property contributed to a partnership or corporation meeting this definition does not qualify for non-recognition treatment. Under the bill, an investment company generally includes any corporation or partnership if more than 80 percent of its assets (by value) consist of money, financial instruments, foreign currency and certain interests in precious metals and entities that hold passive-type assets.

Disallowance of interest on indebtedness allocable to tax-exempt obligations—The bill extends to all corporations (other than insurance companies) the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations (other than nonsalable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government) bears to the average basis of all of the taxpayer's assets. The bill does not extend the small-issuer exception to taxpayers which are not financial institutions, but does provide a de minimis exception if the average adjusted basis of tax exempt obligation is less than the lesser of $1 million or 2 percent of the basis of all of the corporation's assets.

Gains and losses from certain terminations with respect to property—The bill extends the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property. The bill also repeals the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as exchanges.

Determination of original issue discount where pooled debt obligations subject to acceleration—The bill requires credit card issuers and other holders of pools of debt instruments to accrue interest income on such pools using reasonable prepayment assumptions.

Deny interest deduction on certain debt instruments—The bill denies interest deductions on corporate instruments where a substantial amount of interest or principal is mandatorily payable in stock of the issuer or a related party, or is so payable at the option of the issuer or a related party. The provision also applies to instruments that are part of an arrangement designed to result in such payment. The provision is effective for instruments issued after June 8, 1997, unless issued pursuant to a binding written agreement in effect on that date or described in an IRS ruling request or a public announcement or SEC filing on or before such date.

Corporate Organizations and Reorganizations

Require gain recognition for certain extraordinary dividends—Under the bill, 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) where the nontaxed portion of the dividend (under the dividends received deduction) exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, the bill requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The bill 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 or a tender offer outstanding on that date. In applying the new gain 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.

Require gain recognition on certain distributions of controlled corporation stock—If, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation in a section 355 distribution is acquired, gain is recognized by the other corporation as of the date of the distribution. An acquisition occurs if a person or persons acquire 50 percent or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan. Except as provided in regulations, in the case of distributions within an affiliated group of corporations filing a consolidated return, section 355 would not apply to any distribution from one member of the group to another. The bill also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions, reducing the present-law test from 80 percent of vote and of all other classes of stock to a 50 percent of vote and value test. This part of the provision is generally effective for distributions after the date of enactment. The rest of the provision generally is effective for distributions after April 16, 1997. No part of the bill applies to a distribution that is pursuant to a written binding contract, IRS ruling request, or an SEC filing or a public announcement on or before April 16, 1997, in which the unrelated acquiror is identified.

Reform tax treatment of certain corporate stock transfers—Purchases of stock between related corporations that are treated as dividends under section 304 is treated as if the transferor had acquired the stock in exchange for stock of the acquiror and that stock deemed issued had then been redeemed. Basis reduction rules apply. The bill also limits the earnings and profits of an acquiring foreign corporation that would be taken into account in applying section 304. The provision is effective for distributions or acquisitions after June 8, 1997 except that it will not apply to any such distribution made pursuant to a written agreement that was binding on that date, or that was described in an IRS ruling request or SEC filing or public announcement on of before that date.

Modify holding period for dividends-received deduction—A corporation will not be eligible for the dividends received deduction unless it satisfies a holding period requirement with respect to each dividend. The provision is effective for dividends paid or accrued after the 30th day after the date of enactment.

Registration of confidential tax shelters and substantial understatement penalty—The bill requires the registration with the Treasury Department of certain confidential tax shelters and modifies the substantial understatement penalty.

Treat certain preferred stock as "boot"—Certain preferred stock is treated as taxable consideration if received in an otherwise tax-free reorganization or contribution to a corporation. This is preferred stock that does not participate in corporate growth and that includes certain rights to put or redeem the stock within 20 years. Also, stock the dividend rate on which varies with reference to interest rates or certain other indices is within the provision. The provision applies to transactions after June 8, 1997, unless pursuant to a binding written contract in effect on that date or described in an IRS ruling request, SEC filing, or public announcement on or before that date.

Administrative Provisions

Administrative Provisions—The bill provides for information reporting of certain payments made to attorneys, a decrease in the threshold for reporting payments to corporations performing services for Federal agencies, permanently extends the rules relating to disclosure of return information for administration of certain veterans programs, provides for modifications of the lien and levy rules (including the extension of the continuous levy rules to additional types of payments).

Consistency rule for beneficiaries of trusts and estates—The bill requires a beneficiary of an estate or trust to file its return in a manner that is consistent with the information received from the estate or trust, unless the beneficiary identifies the inconsistency.

Excise Tax Provisions

Extension and modification of aviation excise taxes—The bill extends the Airport and Airway Trust Fund excise taxes in passenger and freight transportation for ten years, through September 30, 2007. The bill also modifies the structure of the commercial air passenger tax from 10 percent of the amount paid to a tax equal to the aggregate of 7.5 percent plus $2 per flight segment (phasing up until the pre flight segment reaches $3.00 in 2002). The international departure tax is increased to $15.50 per passenger, and the tax is extended to internationally arriving passengers. The 7.5 percent tax is extended to amounts paid by credit card companies and other companies under marketing arrangements whereby they offer frequent flyer or other reduced airfare provisions to customers and others. The 4.3-cents-per-gallon deficit reduction tax imposed on aviation fuel is transferred to the Airport and Airway Trust Fund, and modifications are made in certain tax deposits. The modifications generally apply to transportation beginning after September 30, 1997.

Extend diesel fuel excise tax rules to kerosene—The bill extends the current diesel fuel excise tax rules to kerosene, subject to limited modifications allowing non-tax-paid sales to registered aviation dealers and certain industrial feedstock users.

Modify tax benefits for ethanol and renewable source methanol—The bill provides for the phase-out of the current tax benefits for ethanol and renewable source methanol through the currently scheduled expiration dates. The phase-out is accomplished through a restriction on production from new facilities, production caps (enforced by an excess production penalty equal to the tax benefits), a reduction in the general 54-cents-per-gallon tax benefit level, and reversal of the Treasury Department regulation providing that ETBE and similar ethers qualify for the tax benefits.

Reinstate Leaking Underground Storage Tank Trust Fund excise tax—The bill extends the pre-1996 excise tax of 0.1 cent per gallon on gasoline, diesel fuel, special motor fuels, aviation fuels, and inland waterway fuels for five years from the date of enactment. Revenues from the reinstated tax will go to the Leaking Underground Storage Tank Trust Fund as under prior law.

Application of communications tax to long-distance prepaid telephone cards—The bill clarifies that payments from persons to communications companies for prepaid telephone cards which are subsequently distributed or resold to the ultimate user of the prepaid telephone card constitute payments for communication services that are subject to the 3-percent communications excise tax.

Tax-Exempt Organizations

Extend UBIT rules to second-tier subsidiaries and amend control test—The bill modifies the test for determining control for purposes of the unrelated business income tax rules contained in section 512(b)(13). Generally, "control" means ownership by vote or value of more than 50 percent of the ownership interests. In addition, the bill applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). The provision generally applies to taxable years beginning after the date of enactment.

Limit increase in basis of property on sale by tax-exempt entity to related person—The bill requires a carryover basis in property transferred by a tax exempt entity to a related party in a sale or exchange, except to the extent of any gain recognized to the seller as unrelated business taxable income. The provision is effective for sales or exchanges after June 8, 1997, unless pursuant to a binding written contract in effect on that date.

Reporting and proxy tax requirements for political and lobbying expenditures—The bill provides that an exemption from the general disclosure requirements and proxy tax of section 6033(e) is available to a tax-exempt organization if more than 90 percent of the amount of aggregate annual dues (or similar payments) received by the organization are paid by (1) individuals or families whose annual dues (or similar amounts) are less than $100, or (2) tax-exempt entities. The provision is effective for taxable years beginning after December 31, 1997.

Repeal grandfather rule with respect to pension business of certain insurers—The provision repeals the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association—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 provision is effective for taxable years beginning after December 31, 1997.

Other Provisions

Phase-out suspense accounts for certain large farm corporations—The bill (1) repeals the ability of family farm corporations with average gross receipts over $25 million to defer income from the required switch from the cash method to an accrual method of accounting by establishing suspense accounts and (2) requires previously-created suspense accounts generally to be restored to income over a period of 20 years.

Modify net operating loss carryback and carryforward rules—The bill reduces the carryback period for net operating losses from three to two years and extends the carryforward period from 15 to 20 years.

Expand the limitations on deductibility of interest and premiums with respect to life insurance, endowment, and annuity contracts—The present-law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract covering the life of any individual, when the taxpayer is directly or indirectly a beneficiary under the contract. Also, 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 covering the life of any individual. In addition, 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. The provisions apply generally with respect to contracts issued after June 8, 1997.

Allocation of basis of properties distributed to a partner by a partnership—The provision modifies the basis allocation rules for distributee partners, generally requiring allocation of basis increases in accordance with the fair market value of the distributed properties rather than in accordance with their basis to the partnership, effective for partnership distributions after the date of enactment.

Treatment of inventory items of a partnership—The provision eliminates the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests and certain partnership distributions. The provision is effective for sales, exchanges, and distributions after the date of enactment.

Treatment of appreciated property contributed to a partnership—The provision extends the 5-year limit on taxation of partners' precontribution gain to 10 years, effective for property contributed to a partnership after June 8, 1997.

Earned income credit ("EIC") compliance provisions—In addition to the establishment of IRS continuous levy and the modifications of levy exemptions (described elsewhere) which also apply to the EIC, the bill provides three compliance measures to address the EIC compliance problem. First, taxpayers who fraudulently claim the EIC are made EIC ineligible for 10 years thereafter. Taxpayers who erroneously claim the EIC due to reckless or intentional disregard of rules or regulations are ineligible to claim the EIC for two years thereafter. Second, taxpayers who are denied the EIC as a result of deficiency procedures are ineligible in subsequent years to claim the EIC unless they provide evidence of eligibility as required by the Secretary of the Treasury. Finally, return preparers are subject to a $100 penalty for each return claiming an EIC with respect to which certain due diligence requirements are not satisfied. These provisions are effective for taxable years beginning after December 31, 1996.

Restrict eligibility for income forecast method—The bill limits the availability of the income forecast method of depreciation to movies, sound recordings, videotapes, books, patents, copyrights, and other similar items. The bill also provides a 3-year recovery period for consumer durable goods leased by rent-to-own businesses.

Require taxpayers to include the rental value of residence in income without regard to period of rental—Gross income for income tax purposes generally includes all income including rents. However, gross income does not include rental income where a dwelling unit is used by the taxpayer as a residence and is actually rented for less than 15 days during the taxable year. Also, no deductions relating to such rental are allowed. The bill repeals the 15-day rules.

Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts—The bill provides that in order for the nonrecognition rules of section 1033 (relating to involuntary conversions) to apply, an individual must acquire replacement property from a unrelated party, subject to a $100,000 de minimis rule.

Repeal of exception for certain sales by manufacturers to dealer—The bill repeals the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

Title XI—Foreign Tax Provisions

General Provisions

Eligibility of licenses of computer software for foreign sales corporation benefits—The bill provides that computer software licensed for reproduction abroad is not excluded from the definition of export property for purposes of the foreign sales corporation provisions. Accordingly, computer software that is exported with a right to reproduce is eligible for the benefits of the foreign sales corporation provisions.

Increase dollar limitation on section 911 exclusion—Under the bill, 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, and is indexed for inflation beginning in 2008.

Simplify foreign tax credit limitation for individuals—The bill exempts 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, from the foreign tax credit limitation rules.

Simplify translation of foreign taxes—The bill generally provides for accrual-basis taxpayers to translate foreign taxes at the average exchange rate for the taxable year to which such taxes relate. The bill also generally provides that, in cases where the foreign taxes actually are paid more than two years after such accrual, such taxes are to be taken into account for the year to which they relate, but are to be translated at the exchange rate for the time of payment.

Election to use simplified foreign tax credit limitation for alternative minimum tax purposes—The bill 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.

Simplify treatment of personal transactions in foreign currency—The bill applies nonrecognition treatment to any exchange gain that results from an individual's acquisition of foreign currency and disposition of it in a personal transaction, provided that such gain does not exceed $200.

Simplify foreign tax credit limitation for dividends from 10/50 companies—Under the bill, a single foreign tax credit limitation generally applies to dividends received by the taxpayer from all so-called 10/50 companies (other than any 10/50 company that qualifies as a passive foreign investment company).

General Provisions Affecting Treatment of Controlled Foreign Corporations

The bill makes several modifications to the treatment of controlled foreign corporations and lower-tier controlled foreign corporations. In addition, the bill extends the application of the indirect foreign tax credit to taxes paid or accrued by fourth- through sixth-tier controlled foreign corporations.

Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap with Subpart F and to Allow Mark-to-Market Election

Under the bill, a shareholder that is subject to the subpart F rules with respect to stock of a passive foreign investment company that is also a controlled foreign corporation is not subject also to the passive foreign investment company provisions with respect to the same stock. The bill also allows a shareholder of a passive foreign investment company to make a mark-to-market election with respect to the stock of the passive foreign investment company, provided that such stock is marketable.

Simplify Formation and Operation of International Joint Ventures

The bill repeals the excise tax that applies to transfers of appreciated property by U.S. persons to certain foreign entities. The bill requires enhanced information reporting by U.S. persons with respect to their interests in foreign partnerships.

Modification of Reporting Threshold for Stock Ownership of a Foreign Corporation

The bill increases the stock ownership threshold that results in an information reporting obligation with respect to a foreign corporation from 5 percent to 10 percent.

Other Foreign Simplification Provisions

Transition rule for certain trusts—The bill grants regulatory authority to allow nongrantor trusts that had been treated as U.S. trusts prior to the enactment of the Small Business Job Protection Act of 1996 to elect to continue to be treated as U.S. trusts.

Repeal of stock and securities safe harbor requirement that principal office be outside the United States—The bill modifies the present-law safe harbor that treats foreign persons that trade stock or securities for their own accounts as not engaged in a U.S. trade or business. For purposes of the safe harbor, the bill eliminates the present-law requirement that the principal office not be within the United States.

Other Foreign Provisions

Inclusion of income from notional principal contracts and stock lending transactions under subpart F—The bill adds to the definition of foreign personal holding company income for subpart F purposes net income from all types of notional principal contracts and payments in lieu of dividends derived from equity securities lending transactions. The bill provides an expanded dealer exception from the definition of foreign personal holding company income.

Restrict like-kind exchange rules for certain property—The bill provides that for the nonrecognition rules of section 1031 (relating to like-kind exchanges) to apply, the property surrendered in the exchange and the party received in the exchange must be both predominantly used either in (or outside) the United States.

Holding period requirement for certain foreign taxes—The bill denies a shareholder the foreign tax credits normally available with respect to a dividend on stock of a foreign corporation or regulated investment company if the shareholder has not held the stock for 16 days, in the case of common stock, or 46 days in the case of preferred stock. An exception is provided for dividends on certain stock held by a foreign securities dealer.

Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons—The bill imposes penalties on foreign persons that do not satisfy the filing requirements for claiming exemption from U.S. tax for income from the international operation of ships or aircraft.

Limitation on treaty benefits for payments to hybrid entities—The bill limits the availability of a reduced rate of withholding tax under an income tax treaty in the case of income derived through a hybrid entity, in order to prevent tax avoidance.

Clarification of determination of foreign taxes deemed paid—The bill clarifies that, for purposes of the indirect foreign tax credit, a foreign corporation's foreign tax pool does not include any taxes that are attributable to dividends distributed by the foreign corporation in prior taxable years.

Clarification of foreign tax credit limitation for financial services income—The bill clarifies that the exclusion from passive income for 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.

Interest on underpayment reduced by foreign tax credit carryback—The bill provides that, 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.

Determination of period of limitations relating to foreign tax credits—The bill provides that, 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.

Title XII—Simplification Provisions Relating to Individuals and Businesses

Individual Simplification Provisions

Modifications to standard deduction of dependents; AMT treatment of certain minor children—The bill 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 (indexed for inflation as under present law), or (b) the individual's earned income plus $250. The bill 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.

Increase estimated tax de minimis threshold—The bill increases the individual estimated tax de minimis threshold from $500 to $1,000.

Optional methods for computing SECA tax combined—The bill simplifies the reporting of self-employment income by combining the optional methods for reporting farm and non farm self-employment income. The provision also ensures that persons reporting self-employment income by the optional method have enough self-employment income to provide four quarters of coverage under the Social Security Act.

Treatment of certain reimbursed expenses of rural mail carriers—The bill simplifies the treatment of certain reimbursed expenses of rural mail carriers.

Travel expenses of Federal criminal investigators—The bill provides for special rules relating to the travel expenses of certain Federal criminal investigators.

Payment of taxes by commercially acceptable means—The bill generally provides for the payment of taxes by any commercially acceptable means.

Provisions Relating to Businesses Generally

Simplification to the look-back method applicable to long-term contracts—The bill simplifies the look-back method applicable to long-term contracts by providing that the method need not be applied to de minimis changes to estimated income and by stream lining the calculation of applicable interest rates used in the look-back calculation.

Minimum tax treatment of certain property and casualty insurance companies—The bill 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.

Partnership Simplification Provisions

The bill makes simplifying changes to reporting and audit rules in the case of electing large partnerships, which are generally those that elect to come within the provisions and that have 100 or more partners for the partnership's preceding taxable year. The bill also provides that electing large partnerships must report to partners by March 15 following the close of the partnership's taxable year. The bill also provides for reporting on magnetic media to the IRS for all partnerships, and modifies the filing threshold for an IRA with an interest in an electing large partnership. In addition, the bill provides modifications and clarifications to the present-law rules governing partnership proceedings that were enacted in 1982 as part of TEFRA.

Modifications of Rules for Real Estate Investment Trusts

Clarification of limitation on maximum number of shareholders—The bill 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 of $25,000 ($50,000 for intentional violations) for failing to do so. 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—The bill permits a REIT to render a de minimis amount (one percent of rents) 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.

Attribution rules applicable to tenant ownership—The bill modifies the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution occurs only when a partner owns a 25 percent or greater interest in the partnership.

Credit for tax paid by REIT on retained capital gains—The bill 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.

Repeal of 30-percent gross income requirement—The bill 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—The bill changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years such that 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.

Treatment of foreclosure property—The bill lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. Under the bill, the grace period could be extended for an additional three years by filing a request to the IRS and a REIT could revoke an election to treat property as foreclosure property for any taxable year.

Payments under hedging instruments—The bill treats income from all hedges (such as an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument) 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.

Excess noncash income—The bill (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—The bill excludes from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages—The bill 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 4 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—The bill 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.

Repeal of the 30-Percent (Or "Short-Short") Test for Regulated Investment Companies

The bill repeals the requirement of a regulated investment company (RIC) that it derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the "30-percent test" or "short-short rule").

Taxpayer Protections

The bill provides a reasonable cause exception for certain additional penalties where one does not now exist, clarifies the period for filing claims for refunds, repeals the authority to disclose otherwise confidential information regarding whether a prospective juror has been audited, clarifies the statute of limitations, clarifies the rules regarding the awarding of administrative costs, and provides a criminal penalty and civil damages for unauthorized inspection of tax returns and return information ("browsing").

Title XIII—Estate, Gift, and Trust Tax Simplification

The bill contains a number of simplification provisions relating to Federal estate, gift and trust taxes that are intended to simplify administration of the Internal Revenue Code.

Title XIV—Excise Tax and Other Simplification Provisions

Excise tax simplification—The bill simplifies taxpayer compliance with numerous excise tax provisions: accessories installed after purchasing heavy trucks and certain automobiles, the treatment of tires under the heavy vehicle retail tax, and expanded exemptions from IRS registration requirements in certain cases. Additionally, the bill includes a number of provisions related to the taxes on distilled spirits, wine, and beer designed to conform the administration of those taxes (1) across beverage types, and (2) to current industry and Bureau of Alcohol, Tobacco, and Firearms preferred practices.

Tax-exempt bond provisions—The bill (1) repeals the $100,000 limitation on unspent proceeds under the 1-year exception from rebate, (2) exempts earnings on bond proceeds invested in a bona fide debt service fund from the arbitrage rebate requirement and the penalty requirement (under the construction bond exception from rebate) if the spending requirements are otherwise satisfied, (3) repeals the 150-percent of debt service yield restriction, and (4) repeals certain student loan bond provisions as deadwood.

Tax Court procedures—The bill provides rules relating to overpayment determinations, to the redetermination of interest pursuant to a motion, and to the application of net worth limitations for awards of litigation costs. The bill also generally provides for Tax Court jurisdiction for the determination of employment status.

Other provisions—The bill provides that the due date of a private foundation's first-quarter estimated tax payment is the same date for filing the foundation's annual return for the preceding year. The bill clarifies the authority to withhold Puerto Rico (and other Commonwealth) income taxes from the salaries of Federal employees. The bill also provides that notices of less than $100,000 are disregarded for purposes of triggering the increased interest rate on certain large corporate underpayments.

Title XV—Technical Corrections

The bill includes a number of technical corrections to previously enacted legislation, including the Small Business Job Protection Act of 1996, Health Insurance Portability and Accountability Act of 1996, Taxpayer Bill of Rights 2, and other recent tax acts.

B. BACKGROUND AND NEED FOR LEGISLATION

Under the Fiscal Year 1998 Budget Resolution (House Con. Res. 84), the Committee on Ways and Means was instructed to report the revenue reconciliation provisions for a net of $85 billion of tax cuts for the first 5 fiscal years (fiscal years 1998–2002) and no more than $250 billion for the 10-year period (fiscal years 1998–2007). The budget resolution was the result of the Balanced Budget Agreement between the Congressional leadership and the President. The revenue reconciliation provisions approved by the Committee reflect the need for tax reduction for families, capital gains relief, savings and investment incentives, estate and gift tax relief to families and closely-held businesses, extensions of certain expiring tax provisions, District of Columbia tax incentives, welfare-to-work tax credit, miscellaneous tax provisions, revenue-offset provisions, tax simplification provisions, tax technical corrections, and an increase in the public debt limit.

C. LEGISLATIVE HISTORY

Committee consideration budget conciliation revenue recommendation

The Committee on Ways and Means (the "Committee") conducted consideration of budget reconciliation revenue recommendations (including tax simplification and technical corrections) on June 11–13, 1997. The Committee's statutory language (referred to in this report as "the bill") for its budget reconciliation revenue recommendations was approved, as amended, on June 13, 1997, by a roll call vote of 22 yeas and 16 nays. The statutory provisions and this explanatory material are to be submitted to the House Committee on the Budget for inclusion in the Budget Committee's report on the Fiscal 1998 Budget Reconciliation Bill.

Committee hearings

Committee and Subcommittee hearings related to various budget reconciliation revenue recommendations have been held during the 105th Congress.

Full Committee hearings

Full Committee hearings were held as follows:

Solvency of the Airport and Airway Trust Fund (February 5, 1997);

President's Fiscal Year 1998 Budget (February 11–12, 1997);

Education and Training Tax Provisions of the Administration Fiscal Year 1998 Budget Proposal (March 5, 1997);

Revenue Raising Provisions in the Administration's Fiscal Year 1998 Budget Proposal (March 12, 1997);

Savings and Investment Provisions in the Administration's Fiscal Year 1998 Budget Proposal (March 19, 1997);

Internal Revenue Service's 1995 Earned Income Tax Credit Compliance Study (May 8, 1997).

Subcommittee hearings

The Oversight Subcommittee held the following hearings related to Internal Revenue Service oversight:

Annual Report of the Internal Revenue Service Taxpayer Advocate (February 25, 1997);

"High-Risk" Programs Within the Jurisdiction of the Committee on Ways and Means (March 4, 1997);

IRS Budget for Fiscal 1998 and the 1997 Tax Return Filing Season (March 18, 1997);

Electronic Federal Tax Payment System (April 16, 1997).

II. EXPLANATION OF THE BILL

TITLE I. CHILD AND DEPENDENT CARE TAX CREDITS; HEALTH CARE FOR CHILDREN

A. CHILD TAX CREDIT FOR CHILDREN UNDER AGE 17 (SEC. 101 OF THE BILL AND NEW SEC. 24 OF THE CODE)

Present Law

In general

Present law does 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.

Dependent care credit

A nonrefundable credit against income tax liability is available for up to 30 percent (phased down to 20 percent for individuals with AGI above $28,000) of a limited dollar amount of employment-related child and dependent care expenses. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual and $4,800 if there are two or more qualifying individuals. Employment-related expenses are expenses for household services and the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. Employment-related expenses are reduced to the extent the taxpayer has employer-provided dependent care assistance that is excludable from gross income.

Reasons for Change

The Committee believes 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 exemption has declined in real terms by over one-third. The Committee believes 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

The bill allows taxpayers a maximum nonrefundable tax credit of $500 ($400 for taxable year 1998) 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. The credit amount is not indexed for inflation.

For taxpayers with modified AGI in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit is phased out. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit is reduced by $25 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). The reduction is applied first to the child credit and then to the dependent care credit. 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.

Beginning after 2001, the otherwise allowable child credit would be reduced by one-half of the amount of the taxpayer's otherwise allowable dependent care credit. This reduction to the otherwise allowable child credit would be applied after the application of the modified AGI phase-out to the child and dependent care credits (if applicable). The maximum amount of the child credit for each taxable year (after the reduction, if any, for the dependent care credit after 2001) could not exceed an amount equal to the excess of: (1) the taxpayer's regular income tax liability (net of applicable credits) over (2) the sum of the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) and the earned income credit allowed.

Effective Date

Generally, the child tax credit is effective for taxable years beginning after December 31, 1997. The provision to reduce the otherwise allowable child credit by one-half of the amount of the taxpayer's dependent care credit is effective for taxable years beginning after December 31, 2001.

B. EXPAND DEFINITION OF HIGH-RISK INDIVIDUALS WITH RESPECT TO TAX-EXEMPT STATE-SPONSORED ORGANIZATIONS PROVIDING HEALTH COVERAGE (SEC. 101(b) OF THE BILL AND SEC. 501(c)(26) OF THE CODE)

Present Law

Present law provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied.[1] 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.

Present law further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

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

Reasons for Change

The Committee believes that including 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 or the taxpayer (or a dependent of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer.

Effective Date

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

C. INDEXING OF THE DEPENDENT CARE CREDIT; PHASE OUT FOR HIGH-INCOME TAXPAYERS (SEC. 102 OF THE BILL AND SECS. 21 AND 26 OF THE CODE)

Present Law

A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses. The credit may be claimed by an individual who maintains a household that includes one or more qualifying individuals. A qualifying individual is a dependent of the taxpayer who is under the age of 13, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse. A married couple must file a joint return in order to claim the credit.

Employment-related expenses are expenses for household services and the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. The amount of employment-related expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse is not employed, no credit is generally allowed. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual, and $4,800 if there are two or more qualifying individuals. The amount of employment-related expenses is reduced by the aggregate amount of employer-provided dependent care assistance excluded from the taxpayer's income.[2]

[2] Up to $5,000 annually of employer-provided dependent care assistance is excludable from gross income if the assistance is provided under a separate written plan of the employer that does not discriminate in favor of highly compensated employees and certain other requirements are satisfied.

The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income ("AGI") above $10,000. A married couple's combined AGI is used for purposes of this computation. Individuals with more than $28,000 of AGI are entitled to a credit equal to 20 percent of allowable employment-related expenses.

Reasons for Change

The Committee believes that, as the costs of dependent care increase as a result of inflation, the size of the credit should also be increased. Also, the Committee believes that the credit should be targeted to lower- and middle-income taxpayers.

Explanation of Provision

The dollar limits on eligible employment-related expenses ($2,400 if there is one qualifying individual and $4,800 if there are two or more qualifying individuals) are indexed for inflation.

The sum of the otherwise allowable dependent care credit and the otherwise allowable child credit is phased out for taxpayers with modified AGI in excess of certain thresholds. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit is reduced by $25 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). The reduction is applied first to the child credit and then to the dependent care credit. 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. These thresholds are not indexed for inflation.

Effective Date

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

TITLE II. EDUCATION TAX INCENTIVES

A. TAX BENEFITS RELATING TO EDUCATION EXPENSES

1. HOPE credit for higher education tuition expenses (sec. 201 of the bill and new sec. 25A of the Code)

Present 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 June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

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.[3] "Qualified higher education expenses" include tuition and fees (but not room and board expenses)

[3] 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 bears to the aggregate redemption amount (sec. 135(b)).

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. 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 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 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 limitation 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 of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships 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.

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.

Qualified State prepaid 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 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). Qualified higher education expenses do not include 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.[4]

Reasons for Change

To assist low- and middle-income families and students in paying for the costs of post-secondary education, the Committee believes that taxpayers should be allowed to claim a credit against Federal income taxes for certain tuition and related expenses incurred during a student's first two years of attendance (on at least a half-time basis) at a college, university, or certain vocational schools.

Explanation of Provision

In general

Individual taxpayers are allowed to claim a non-refundable HOPE credit against Federal income taxes up to $1,500 per student per year for 50 percent of qualified tuition and related expenses (but not room and board expenses) paid for the first two

[4] 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.

years of the student's post-secondary education in a degree or certificate program. The qualified 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. Beginning in 1998, the maximum credit amount of $1,500 will be indexed for inflation, rounded down to the closest multiple of $50.[5]

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). Beginning in 2001, the income phase-out ranges will be indexed for inflation, rounded down to the closest multiple of $5,000.

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 expenses paid with the proceeds of a loan generally are eligible for the HOPE credit (rather than repayment of the loan itself).[6]

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 or proposed deduction for qualified higher education expenses

For each taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit or the proposed deduction for qualified higher education expenses (described below). Thus, for example, if a parent claims a child as a dependent for a taxable year, then all qualified tuition 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 deduction for qualified higher education expenses with respect to the dependent child (as described below).[7]

[5] The HOPE credit may not be used to reduce any alternative minimum tax (AMT) liability owed by the taxpayer.

[6] The Treasury Department is granted authority to issue regulations providing that the HOPE credit will be recaptured in cases where the student or taxpayer receives a refund of tuition and related expenses with respect to which a credit was claimed in a prior year.

[7] 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 proposed deduction (described

Continued

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 deduction for qualified higher education expenses paid during that year.

Qualified tuition and related expenses

The HOPE credit is available for "qualified tuition and related expenses," meaning tuition, fees, and books 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 expenses of education involving sports, games, or hobbies are not qualified tuition 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.[8]

Eligible student

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.) An eligible student may not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

below) for higher education expenses paid 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 proposed deduction for higher education expenses may be available with respect to that student for subsequent taxable years.

[8] In addition, the bill 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 HOPE credit allowed to any taxpayer with respect to the student for the taxable year.

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, 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 (in consultation with the Secretary of Education) is granted authority to issue regulations to implement the proposal, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations may address the information reports that eligible educational institutions will be required to file to assist students and the IRS in calculating the amount of the HOPE credit potentially available. Where certain terms are defined by reference to the Higher Education Act of 1965, the Secretary of Education has authority to issue regulations, as well as authority to define other education terms as necessary.

Effective Date

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

2. Deduction for qualified higher education expenses and tax treatment of qualified tuition programs and education investment accounts (secs. 202, 211, and 212 of the bill and sec. 529 and new secs. 222 and 530 of the Code)

Present 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 June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

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.[9] "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. 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 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 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

[9] 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 bears to the aggregate redemption amount (sec. 135(b)).

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 limitation 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 of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships 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.

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.

Qualified State prepaid 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 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). Qualified higher education expenses do not include 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.[10]

Contributions made to a qualified State tuition program are treated as incomplete gifts for Federal gift tax purposes (sec. 529(c)(2)). Thus, any Federal gift tax consequences are determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program is treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) are includible in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program (sec. 529(c)(4)).

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). If the individual (or his or her

[10] 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.

spouse, if married) is an active participant, the $2,000 limit is 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.

Present law permits 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. 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 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 59½, 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.

Reasons for Change

To encourage families and students to save for future education expenses, the Committee believes that tax-exempt status should be granted to certain prepaid tuition programs operated by States or private educational institutions and to education investment accounts established by taxpayers on behalf of future students. The Committee further believes that a deduction should be allowed for Federal income tax purposes for earnings withdrawn from such prepaid tuition programs and education investment accounts if the earnings are used pay for qualified higher education expenses of an undergraduate student who is attending a college, university, or certain vocational schools on at least a half-time basis.

Explanation of Provision

In general

Individual taxpayers are allowed a deduction of up to $10,000 per student per year for qualified higher education expenses paid by the taxpayer during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, or a dependent. The deduction is allowed regardless of whether the taxpayer otherwise itemizes deductions or claims the standard deduction.[11] A deduction is not allowed under the bill with respect to an otherwise eligible student

[11] The deduction will be claimed after a taxpayer computes adjusted gross income (AGI). The deduction is not a preference item for alternative minimum tax (AMT) purposes.

if the HOPE credit (as described previously) is claimed with respect to that student for the same taxable year.[12]

The deduction is allowed only to the extent that the taxpayer is required to include in gross income for the taxable year amounts distributed from a "qualified tuition program" or "education investment account." In other words, amounts distributed from a qualified tuition program or education investment account that are includible in the taxpayer's gross income (i.e., earnings) and that are used to pay for qualified higher education expenses during the taxable year will be deductible under the bill (subject to a $10,000 annual limit per student). Amounts distributed from qualified tuition programs or education investment accounts generally will 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 under any other section, such as section 117).

Under the bill, the deduction is limited to $10,000 per student for each taxable year. Aggregate deductions under the bill with respect to any one student may not exceed $40,000 for all taxable years. A deduction is not permitted with respect to a student after he or she completes the equivalent of the first four years of post-secondary education at an eligible educational institution.

Dependent students

If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then only the parent (or other taxpayer)—and not the student—may claim the deduction for qualified higher education expenses for that taxable year. In such a case where the parent claims the proposed deduction for qualified higher education expenses, amounts includible in gross income by reason of a distribution from a qualified tuition program or education investment account will be includible in the parent's (or other taxpayer's) gross income for that taxable year.[13] If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then all qualified higher education expenses paid that year by both the parent (or other taxpayer) and the student are deemed to be paid by the parent (or other taxpayer). If the student is not claimed as a dependent by another taxpayer, then only the student him- or herself may claim the deduction provided for by the bill (or, as an alternative, the HOPE credit described above) on the student's own tax return for the taxable year.[14]

[12] If a HOPE credit was claimed with respect to a student for an earlier taxable year (i.e., the student's first or second year of post-secondary education), the deduction provided for by the bill may be claimed with respect to that student for a subsequent taxable year.

[13] Such an income inclusion is required on the parent's return only if the parent both claims the student as a dependent and elects the deduction provided for by the bill. In contrast, if the parent claims the student as a dependent but elects the HOPE credit, then, if there is any distribution from a qualified tuition program or education investment account during that year, the earnings portion of such distributions will be includible in the student's (or other distributee's) gross income, as provided for by present-law section 529(c)(3).

[14] For example, assume an education investment account (or qualified tuition program account) has a balance of $20,000, of which $12,000 represents contributions of principal and $8,000 represents accumulated earnings. If the student has expenses of $10,000 consisting of $7,000 tuition and related expenses and $3,000 in room and board, a distribution of $10,000 from such account to pay these expenses will, under present-law section 72, be deemed to consist of the pro-rata share of principal and accumulated earnings in the account—in this case, $6,000 in principal and $4,000 in accumulated earnings. If the parent claims the student as a dependent and elects the proposed deduction for qualified higher education expenses, the parent will include the $4,000 of accumulated earnings in the parent's gross income and then is allowed to claim an offsetting deduction for the same $4,000, thus resulting in no tax liability for the

Qualified higher education expenses

Under the bill, the term "qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, as well as 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). Qualified higher education expenses do not include expenses for any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree.

Qualified higher education expenses generally include only out-of-pocket expenses. 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 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. In addition, no deduction is allowed under the bill for expenses paid with amounts that are excludible under section 135. No reduction of qualified tuition expenses is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under section 162 or any other section of the Code, then no deduction is available for such expenses under the bill.

Eligible students

To be eligible for the deduction provided for by the bill, a student must be at least a half-time student in a degree or certificate program at an eligible educational institution. For this purpose, a student is at least a half-time student if, during at least one academic period which begins during the taxable year, he or she is carrying at least one-half the normal full-time work load for the course of study the student is pursuing. A student will no longer be an eligible student once he or she has completed the equivalent of the first four years of post-secondary education at an eligible educational institution. An eligible student may not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

$4,000 in earnings. Under no circumstances will the principal portion of any distribution from the account be includible in gross income, nor will a deduction be allowed under the bill for education expenses paid with such principal. Alternatively, the parent may elect to claim the HOPE credit (assuming that the AGI phaseout does not apply and the student is claimed as a dependent and has not yet completed the first two years of post-secondary education), and the $4,000 in accumulated earnings will be includible in the distributee's (i.e., the student's) gross income and an offsetting deduction will not be available. Additionally, the qualified expenses for purposes of the HOPE credit will not include room and board expenses, so only $7,000 in expenses will qualify for the HOPE credit. The 50-percent HOPE credit rate will then be applied to this amount, which indicates a credit amount of $3,500, but the credit that could be claimed will be limited to the statutory maximum of $1,500 per student. As a final alternative, if the parent does not claim the student as a dependent, then the student may elect to claim either the HOPE credit or the deduction as described above.

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, 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.

Qualified tuition programs and education investments accounts

Under the bill, a "qualified tuition program" means any qualified State tuition program, generally as defined under present-law section 529, as well as any program established and maintained by one or more eligible educational institutions (which may be private institutions that are not State-owned) that satisfy the requirements under section 529 (other than present-law, State ownership rule). An "education investment account" means a trust which is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder and which satisfies certain other requirements.

Contributions to qualified tuition programs or education investment accounts may be made only in cash.[15] Such contributions may not be made after the designated beneficiary or account holder reaches age 18. Any balance remaining in a qualified tuition program or education investment account must be distributed within 30 days after the earlier of the date that the beneficiary or account holder becomes 30 years old (or dies) or the date that the beneficiary or account holder completes the equivalent of the first four years of post-secondary education at one or more eligible institutions. Transfers or rollovers of credits or account balances from one account benefiting one beneficiary to another account benefiting another beneficiary will not be considered a distribution from a qualified tuition program or education investment account (nor will a change in the designated beneficiary or account holder) if the new beneficiary is a member of the family of the old beneficiary.[16] In the case of an education investment account or qualified tuition program maintained by one or more private educational institutions, contributions to an account established on behalf of a particular beneficiary (or to a program on behalf of a named beneficiary) may not exceed $5,000 per year, with an aggregate limit of $50,000 for contributions on behalf of that beneficiary for all years. The $50,000 aggregate contribution limit per beneficiary is applied

[15] The bill 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 a qualified tuition program or education investment account on behalf of the taxpayer, the taxpayer's spouse, or a dependent, In such a case, the beneficiary's or account holder's basis in the bond proceeds contributed on his or her behalf to the qualified tuition program or education investment will be the contributor's basis in the bonds (i.e., the original purchase price paid by the contributor for such bonds).

The bill also provides that funds from an education investment account are deemed to be distributed to pay qualified higher education expenses if the funds are used to purchase tuition credits from, or to make contributions to, a qualified tuition program for the benefit of the account holder.

[16] For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a), and any spouse of such persons.

by taking into account all amounts contributed to all education investment accounts for the beneficiary for the current taxable year and all prior taxable years, as well as all amounts contributed to all qualified tuition programs on behalf of such beneficiary for the current taxable year and all prior taxable years.[17]

Qualified tuition programs and education investment accounts (as separate legal entities) will be exempt from Federal income tax, other than taxes imposed under the present-law unrelated business income tax (UBIT) rules.[18]

Under the bill, an additional tax of 10 percent will be imposed on distributions from qualified tuition programs or education investment account to the extent the distribution exceeds qualified higher education expenses paid by the taxpayer (and is not made on account of the death, disability, or scholarship received by the designated beneficiary or account holder).

Estate and gift tax treatment

For Federal estate and gift tax purposes, any contribution to a qualified tuition program or education investment account will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Thus, annual contributions—which cannot exceed $5,000 per year in the case of an education investment account or qualified tuition program maintained by one or more private education institutions—will be eligible for the present-law gift tax exclusion provided by Code section 2503(b) and also will be 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 $10,000 gift-tax exclusion limit). Similar gift tax and generation-skipping tax treatment will apply to contributions of up to $10,000 per donor per beneficiary made to a State-sponsored qualified tuition program. Contributions to a qualified tuition program (either a State-sponsored program or one maintained by a private education institution) or to an education investment account 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 tuition program or education investment account be treated as a taxable gift.

Transfers or rollovers of credits or account balances from an account benefiting one beneficiary to an account benefiting another beneficiary (or a change in the designated beneficiary) will not be treated as a taxable gift to the extent that the new beneficiary is: (1) a member of the family of the old beneficiary (as defined above),

[17] To the extent contributions exceed the $50,000 aggregate limit, an excise tax penalty may be imposed on the contributor under present-law section 4973, unless the excess contributions (and any earnings thereon) are returned to the contributor before the due date for the return for the taxable year in which the excess contribution is made.

State-sponsored qualified tuition programs will continue to be governed by the rule contained in present-law section 529(b)(7) that such programs provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. State-sponsored qualified tuition programs will not be subject to a specific dollar cap under section 529 on annual (or aggregate) contributions that can be made under the program on behalf of a named beneficiary.

[18] An interest in a qualified tuition program is not treated as debt for purposes of the debt-financed property UBIT rules of section 514.

and (2) assigned to the same generation as the old beneficiary (within the meaning of Code section 2651). In all other cases, a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion. Thus, a transfer of an account from a brother to his sister will not be treated as a taxable gift, whereas a transfer from a father to his son will be treated as a taxable gift (to the extent it exceeds the $10,000 present-law gift tax exclusion).

For estate tax purposes, the value of any interest in a qualified tuition program or education investment account will be includible in the estate of the designated beneficiary. In no event will such interests be includible in the estate of the contributor.

Effective Date

The deduction for qualified higher education expenses, and the expansion of the definition of qualified higher education expenses under sec. 529 to cover room and board expenses, are effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date. The provisions governing the tax-exempt status of qualified tuition plans and education investment accounts generally are effective after December 31, 1997. The gift tax provisions are effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions are effective for decedents dying after June 8, 1997.

3. Phase out qualified tuition reduction exclusion (sec. 202(c) of the bill and sec. 117(d) of the Code)

Present Law

Under present law, a "qualified tuition reduction" is excluded from gross income (sec. 117(d)). A "qualified tuition reduction" means any reduction in tuition provided to an employee of an educational organization for the education of the employee,[19] the employee's spouse, and dependent children at that organization or another such organization. For this purpose, qualifying educational organizations are those that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried out. In general, the qualified tuition reduction is limited to education below the graduate level; however, this limitation does not apply to graduate students engaged in teaching or research activities. The exclusion does not apply to any amount that represents payment for teaching, research, or other services rendered by the student in exchange for receiving the tuition reduction.

[19] Eligible beneficiaries also include retired and disabled employees, surviving spouses of retired or disabled employees,and children of deceased employees if the children are under the age of 25.

Reasons for Change

The Committee believes that because employees of educational organizations, like other taxpayers, will enjoy the special education tax benefits relating to education expenses, as well as the expanded education savings opportunities contained in the bill, the exclusion under 117(d) is no longer necessary.

Explanation of Provision

The bill phases out the special rule contained in section 117(d) that excludes qualified tuition reductions from gross income. For 1998, 80 percent of a qualified tuition reduction is excludable from gross income. For 1999, the excludable percentage is 60 percent; for 2000, the excludable percentage is 40 percent; and for 2001, the excludable percentage is 20 percent. No exclusion for a qualified tuition reduction is permitted after 2001.

Educational benefits provided that are not excludable under the bill may be eligible for the proposed HOPE credit, or may be eligible for the deduction for qualified higher education expenses (described above) to the extent that earnings are distributed from an education investment account on behalf of the student during the year that the education benefits are provided.

Effective Date

The provision is effective for qualified tuition reductions with respect to courses of instruction beginning after December 31, 1997 (subject to the phaseout described above).

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

Present Law

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). 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 homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

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. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70½.

Amounts held in an IRA 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 Committee believes that it is 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 bill provides that the 10-percent early withdrawal tax does not apply to distributions from IRAs (including American Dream IRAs added by the bill) 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 individual or the individual's spouse.

The penalty-free withdrawal is available for "qualified higher education expenses," meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). 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.

5. Tax credit for expenses for education which supplements elementary and secondary education (sec. 204 of the bill and new sec. 25B of the Code)

Present Law

In general, taxpayers may not deduct education and training expenses that relate to basic elementary or secondary education. (Treas. reg. sec. 1.162–5). Students who are employed may be eligible for the special exclusion for employer-provided educational assistance under section 127. In addition, qualified scholarships received by such students are excluded from gross income under section 117, and such students may be eligible for the special rules for student loan forgiveness under section 108(f). No tax credit is available under present law for expenses incurred with respect to elementary or secondary education.

Reasons for Change

The Committee believes that, in addition to making higher education accessible and affordable through various tax incentives, it is important to ensure that students have the necessary academic background to pursue successfully such higher education objectives. To this end, the Committee has provided assistance to students who may require supplementary education with respect to basic elementary and secondary school courses of study to assist such students in obtaining a solid educational foundation.

Explanation of Provision

The bill provides a nonrefundable tax credit equal to the lesser of (1) $150 or (2) 50 percent of qualified educational assistance expenses paid with respect to an eligible student.

Eligible students are children under age 18 enrolled full-time in elementary or secondary school. Qualified educational assistance expenses are costs of supplementary education (e.g., tutoring). Such supplementary education must be provided with respect to a student's current classes by a supplementary education service provider that is accredited by an accreditation organization recognized by the Secretary of Education. Qualified expenses do not include the cost of courses that prepare students for college entrance exams.

The credit is phased out for taxpayers with adjusted gross income between $80,000–$92,000 for joint filers and between $50,000–$62,000 for individual filers.

Effective Date

The credit is available for taxable years beginning after December 31, 1997.

B. OTHER EDUCATION-RELATED TAX PROVISIONS

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

Present Law

Under present 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. The exclusion does not apply to graduate level courses beginning after June 30, 1996. The exclusion expires with respect to courses beginning after June 30, 1997. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Description of Proposal

The proposal would extend the exclusion for employer-provided educational assistance to courses of instruction beginning before

December 31, 1997. As under present law, the exclusion will not apply to graduate-level courses.

Effective Date

The provision would be effective with respect to taxable years beginning after December 31, 1996.

2. Modification of $150 million limit on qualified 501(c)(3) bonds other than hospital bonds (sec. 222 of the bill and sec. 145 of the Code)

Present 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 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. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Reasons for Change

The committee believes that the present law $150 million limitation is inappropriately low.

Description of Proposal

The $150 million limit is increased annually in $10 million increments until it is $200 million. Specifically, the limitation is $160 million in 1998, $170 million in 1999, $180 million in 2000, $190 million in 2001, and $200 million in 2002 and thereafter.

Effective Date

The provision is effective on January 1, 1998.

3. Enhanced deduction for corporate contributions of computer technology and equipment (sec. 223 of the bill and new section 170(e)(6) of the Code)

Present 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.[20] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. 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[21] contributions of inventory property for the care of the ill, the needy, or infants (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)).[22] 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. However, the augmented deduction cannot exceed twice the basis of the donated property.

Reasons for Change

The Committee believes 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 bill expands the list of qualified contributions that would qualify for the augmented deduction currently available under Code section 170(e)(3) and 170(e)(4). Under the bill, qualified contributions mean gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber

[20] 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)). 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.

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

[22] 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.

optic cable related to computer use) to be used within the United States for educational purposes in any of grades K–12.

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. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The bill permits payment by the donee organization of shipping, transfer, and installation costs.[23] 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 1997.

4. Treatment of cancellation of certain student loans (sec. 224 of the bill and section 108(f) of the Code)

Present 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

[23] In the case of contributions made through private foundations, the bill permits the payment by the private foundation of shipping, transfer, and installation costs.

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 Committee believes that it is appropriate to expand present-law section 108(f), so that certain loan cancellation programs of tax-exempt charitable organizations (e.g., private educational institutions) receive Federal income tax treatment comparable to that provided for similar government-sponsored programs. This provision will promote the establishment of programs that encourage students to use their education and training in valuable community service. In addition, the Committee believes it is appropriate to expand section 108(f) to cover forgiveness of certain Federal direct student loans.

Explanation of Provision

The bill expands section 108(f) so that an individual's gross income does not include forgiveness of loans made by tax-exempt charitable organizations (e.g., educational organizations or private foundations) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans 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 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 by tax-exempt charitable organizations, the student's work must fulfill a public service requirement. 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.

The exclusion also is expanded to cover forgiveness of direct student loans made through the William D. Ford Federal Direct Loan Program where loan repayment and forgiveness are contingent on the borrower's income level and any unpaid amounts are forgiven in full by the Secretary of Education at the end of a 25-year period. Thus, Federal Direct Loan borrowers who have elected the income-contingent repayment option and who have not repaid their loans in full at the end of a 25-year period would not be required to include the outstanding loan balance in income as a result of the forgiveness of the loan.

Effective Date

The provision applies to discharges of indebtedness after the date of enactment.

TITLE III. SAVINGS AND INVESTMENT TAX INCENTIVES

A. AMERICAN DREAM IRAS (SEC. 301 OF THE BILL AND NEW SEC. 408A OF THE CODE)

Present Law

Under present 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 (and, if married, the individual's spouse also is not an active participant in such a plan). 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.

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. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70½.

Amounts held in an IRA 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.

In general, distributions from an 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.

A 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The dollar limit is indexed for inflation. A similar 15-percent additional estate tax applies to excess retirement accumulations upon the death of the individual. The 15-percent tax on excess distributions (but not the 15-percent additional estate tax) does not apply to distributions in 1997, 1998, or 1999.

Reasons for Change

The Committee is concerned about the national savings rate, and believes that individuals should be encouraged to save. The Committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive is not available to all taxpayers under present law. Further, the present-law income thresholds for IRA deductions are not indexed for inflation so that fewer Americans will be eligible to make a deductible IRA contribution each year, and the amount of the maximum contribution is declining in real terms over time. The Committee believes it is appropriate to encourage individual saving and that tax-favored savings vehicles should be available to more individuals.

In addition, the Committee believes 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 may find such a vehicle more suitable for their savings needs.

The Committee believes that providing an incentive to save for certain special purposes is appropriate. The Committee believes that many Americans may have difficulty saving enough to purchase a home. Home ownership is a fundamental part of the American dream.

Explanation of Provision

In general

The bill replaces present-law nondeductible IRAs with new American Dream IRAs ("AD IRAs") to which all individuals may make nondeductible contributions of up to $2,000 annually. Contributions to an AD IRA are in addition to any contributions that can be made to a deductible IRA under the present-law rules. No income limitations apply to AD IRAs. An AD IRA is an IRA which is designated at the time of establishment as an AD IRA in the manner prescribed by the Secretary. Qualified distributions from an AD IRA are not includible in income.

Contributions to AD IRAs

The maximum annual contribution that may be made to an AD IRA is the lesser of $2,000 or the individual's compensation for the year. As under the present-law rules relating to deductible IRAs, a contribution of up to $2,000 for each spouse may be made to an AD IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The $2,000 contribution limit is adjusted annually for inflation beginning after 1998 (in $50 increments).

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

Taxation of distributions

Qualified distributions from an AD 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 an AD IRA[24], 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) for first-time homebuyer expenses.

Distributions from an AD 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 AD IRAs. Thus, the following distributions from an AD IRA are not subject to the 10-percent early withdrawal tax: (1) distributions after age 59½; (2) distributions after death or disability of the AD IRA owner; (3) certain periodic distributions; (4) distributions for medical expenses in excess of 7.5 percent of adjusted gross income; (5) distributions for medical insurance of unemployed individuals; and (6) distributions for higher education expenses.[25] In addition, the 10-percent early withdrawal tax does not apply to amounts withdrawn from an AD IRA used to pay first-time homebuyer expenses.[26]

Under the bill, qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the individual's lifetime that are used within 60 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 bill 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 bill, any amount withdrawn for the purchase of a principal residence is required to be used within 60 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals is imposed with respect to any amount not so used. If the 60-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 the AD IRA prior to the end of the 60-day period without adverse tax consequences.

An ordering will 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 an AD

[24] As is the case with IRAs generally, contributions to an AD IRA may 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 an AD 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.

[25] This exception to the early withdrawal tax is added by the bill.

[26] This exception to the early withdrawal tax does not apply to IRAs other than AD IRAs.

IRA are treated as made from contributions first, and all an individual's AD IRAs are treated as a single AD IRA. Thus, no portion of a distribution from an AD IRA is treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's AD IRAs exceeds the amount of contributions.

The pre-death minimum distribution rules that apply to IRAs do not apply to AD IRAs, and amounts in AD IRAs are not taken into account for purposes of the excise tax on excess distributions or the additional estate tax on excess accumulations.

Distributions from an AD IRA may be rolled over tax free to another AD IRA.

Conversions of IRAs to AD IRAs

All or any part of amounts in a present-law deductible or nondeductible IRA may be converted into an AD IRA after December 31, 1997, and before January 1, 1999. The amount that would have been includible in gross income if the individual had withdrawn the converted amounts are 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.[27]

A conversion of an IRA into an AD IRA may be made in a variety of different ways and with or without taking a distribution. For example, a conversion could be made by taking a distribution from an IRA and rolling it over within 60 days to an AD IRA. Or, an individual may make a conversion simply by notifying the IRA trustee. An individual also 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 an AD IRA, the AD IRA amounts have to be held separately.

Effective Date

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

B. CAPITAL GAINS PROVISIONS

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

Present 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 is taxed at the same rate as ordinary income, except that individuals are 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.

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

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 Committee believes 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 and exploit new market opportunities. The greater the pool of savings, the greater the monies available for business investment in equipment and research. It is through such investment in equipment and new products and services 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 net personal saving rate in the United States has averaged less than 5 percent of gross domestic product (GDP) for the past 15 years. The Committee believes such saving is inadequate to finance the investment that is needed to equip the country's businesses with the equipment and research dollars necessary to create the higher productivity that results in higher real wages for working Americans. A reduction in the taxation of capital gains increases the rate of return on household saving. Testimony by many economists before the Committee generally concluded that increasing the after-tax return to saving should increase the saving rate of American households.

American technological leadership has been enhanced by the willingness of individuals to take the risk of pursuing new businesses exploiting new technologies. Risk taking is stifled if the taxation of any resulting gain is high and the ability to claim losses is limited. The Committee believes it is important to encourage risk taking and believes a reduction in the taxation of capital gains will have that effect.

Reduction in the taxation of capital gains also should improve the efficiency of the capital markets. The taxation of capital gains upon realization encourages investors who have accrued past gains to keep their monies "locked in" to such investments even when better investment opportunities present themselves. All economists that testified before the Committee agreed that reducing the rate of taxation of capital gains would encourage investors to unlock many of these gains. This unlocking will permit more monies to flow to new, highly valued uses in the economy. When monies flow freely, the efficiency of the capital market is improved.

The unlocking effect also has the short-term and long-term effect of increasing revenues to the Federal Government. The current revenue estimating methods employed by the Congress account for this long-term behavioral response. Nevertheless, current Congressional estimates project that revenue losses to the Federal Government will arise from the reduction in the tax rate on capital gains. The Committee observes, however, that the conservative approach embodied in such estimates does not attempt to account for the potential for increased growth in GDP that can result from increased saving and risk taking. Many macroeconomists have concluded that reductions in the taxation of capital gains may increase GDP and wage growth sufficiently that future tax revenues from the taxation of wages and business profits will offset the losses forecast from the sale of capital assets. The potential for future growth and its benefits both for all United States citizens and for future Federal revenues were important considerations for the Committee.

The Committee rejects the narrow view that reductions in the taxation of capital gains benefit primarily higher-income Americans. Taking a longer view, the Committee sees a reduction in the taxation of capital gains as providing potential benefits to all individuals. Most importantly, the Committee stresses that economic growth benefits all Americans. Increased investment leads to greater productivity and leads to higher wages. Traditional attempts to measure the benefit or burden of a tax change do not account for this critical outcome.

Explanation of Provision

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

The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles will remain at a maximum rate of 28 percent; any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) to the extent the gain would have been treated as ordinary income if the property had been section 1245 property will be taxed at a maximum rate of 26 percent; and the tax treatment of small business stock (as defined in section 1202(c)) will remain unchanged. Gain from the disposition of a collectible which is an indexed asset (described below) will not be eligible for the 28-percent rate unless the taxpayer elects to forego indexing.

Effective Date

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

For a taxpayer's year that includes May 7, 1997, the lower rates will not apply to an amount equal the net capital gain determined by including only gain or loss properly taken into account for the portion of the taxable year before May 7, 1997. Any net capital gain not eligible for the lower rates will be subject to the present-law maximum rate of 28 percent. 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 remaining portion of the net capital gain to a maximum rate of 28 percent.

In the case of gain taken into account by a pass-through entity (i.e., a RIC, a REIT, a partnership, an estate or trust, or a common trust fund), the date taken into account by the entity is the appropriate date for applying the rule in the preceding paragraph. Thus, gain taken into account by a pass-through entity before May 7, 1997 is not eligible for the lower rates.

The provision also changes the 110-percent-of-last-year-liability estimated tax safe harbor to a 109-percent-of-last-year-liability safe harbor for 1997.

2. Indexing of basis of certain assets for purposes of determining gain (sec. 312 of the bill and new sec. 1022 of the Code)

Present Law

Under present law, gain or loss from the disposition of any asset generally is the sales price of the asset is reduced by the taxpayer's adjusted basis in that asset. The taxpayer's adjusted basis generally is the taxpayer's cost in the asset adjusted for depreciation, depletion, and certain other amounts. No adjustment is allowed for inflation.

Reasons for Change

Because a taxpayer's adjusted basis for tax purposes is determined by historical cost, a taxpayer can have gains for tax purposes even though the real value of the assets (i.e., adjusted for inflation) has not increased. Even at modest inflation rates of three percent per year for five years, an investor's adjusted basis will under-represent his real purchasing power by 16 percent over five years. The taxation of these inflationary gains discourages new saving and investors from selling old investments even when better investment opportunities present themselves. This retards economic growth and leads to an inefficient allocation of capital by the capital markets. For this reason, the Committee believes it is appropriate to provide for inflation adjustments to a taxpayer's adjusted basis in certain assets (held for more than three years) for purposes of determining gain on their disposition.

Explanation of Provision

In general

The bill generally provides for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") held more than 3 years for purposes of determining gain (but not loss) upon a sale or other disposition of such assets by a taxpayer other than a C corporation. Assets held by trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships are eligible for indexing, to the extent gain on such assets is taken into account by taxpayers other than C corporations.

The bill applies to assets acquired on or after January 1, 2001.

Indexed assets

Assets eligible for the inflation adjustment generally include common (but not preferred) stock of C corporations and tangible property that are capital assets or property used in a trade or business. A personal residence is not eligible for indexing. To be eligible for indexing, an asset must be held by the taxpayer for more than three years.

The adjusted basis of debt is not indexed. The proposal also excludes from indexing intangible assets, such as options, futures, and other derivatives.

Computation of inflation adjustment

The inflation adjustment under the provision is computed by multiplying the taxpayer's adjusted basis in the indexed asset by an inflation adjustment percentage. The inflation adjustment percentage is the percentage by which the chain-type price index for GDP (as reported by the Commerce Department's Bureau of Economic Analysis) for the last calendar quarter ending before the disposition exceeds the chain-type price index for GDP for the last calendar quarter ending before the asset was acquired by the taxpayer. The inflation adjustment percentage is rounded to the nearest one-tenth of a percent. No adjustment is made if the inflation adjustment is one or less.

Indexing with respect to any asset ends at the time the asset is treated as disposed of for tax purposes. Thus, with respect to installment sales, the inflation adjustment to the seller does not take into account any periods after the sale is made. The purchaser generally is entitled to inflation adjustments beginning with the date of purchase, even though the purchase price is not paid until a later date.

In computing the inflation ratio, periods of time for which an asset is not an indexed asset are not taken into account. For example, if convertible debt is converted into common stock, the period prior to conversion is disregarded in determining the inflation ratio applicable to the disposition of the common stock.

Special entities

RICs and REITs

In the case of a RIC or a REIT, the indexing adjustments generally apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, are not applicable in determining whether a corporation qualifies as a RIC or REIT.

In order to deny the benefit of indexing to corporate shareholders of the RIC or REIT, the bill provides that, under regulations, (1) the determination of whether a distribution to a corporate shareholder is a dividend is made without regard to this provision, (2) the amount treated as a capital gain dividend is increased to take into account that the amount distributed was reduced by reason of the indexing adjustment, and (3) such other adjustments as are necessary shall be made to ensure that the benefits of indexing are not allowed to corporate shareholders.

In the case of shares held in a RIC or REIT, partial indexing generally is provided by the provision based on the ratio of the value of indexed assets held by the entity to the value of all its assets. The ratio of indexed assets to total assets is determined quarterly (for RICs, the quarterly ratio is based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares is allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing is allowed for that quarter for the shares. Partnership interests held by a RIC or REIT are subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT are indexed.

A return of capital distribution by a RIC or REIT generally is treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.

Under the provision, stock in an S corporation or an interest in a partnership or common trust fund is not an indexed asset.[28] This rule avoids the complexity that would result in determining the proper measure of the basis adjustment if indexing were to take into account the fluctuating basis of the S corporation stock or partnership interest attributable to earnings and distributions or to the frequently changing mix of assets (i.e., indexed assets and other assets) of the entity. Under the provision, the individual owner receives the benefit of the indexing adjustment when the S corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, any inflation adjustments at the entity level flows through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity. Where a partnership has a section 754 election in effect, a partner transferring his interest in the partnership is entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner is entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment is disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Example 1.—A, B, and C form an equal partnership, and each contributes $50 cash. The partnership purchases common stock in corporation X for $150. At a time when the indexed basis to the partnership for the stock is $240, the partnership sells the stock for $300. Under the bill, the partners collectively recognizes $60 gain. Each partner takes into account $20 gain and increases his basis in his partnership interest by the $20 gain (under present law sec. 705). In addition, under the bill each partner increases his basis for purposes of determining gain on his partnership interest by $30 (his share of the $90 indexing adjustment made by the partner-

[28] An interest in a real mortgage investment conduit ("REMIC") or a financial asset securitization investment trust ("FASIT") also are not indexed assets, since REMICs and FASITs are not treated as corporations for income tax purposes.

ship). Thus, if any partner sells his partnership interest for $100, no gain or loss is recognized to the partner.

Example 2.—Same facts as in Example 1, except that the partnership does not sell the stock. Rather, partner A sells his partnership interest to D for $100. The partnership does not have an election under section 754 in effect. Partner A recognizes $50 of gain. Partner D's basis in the partnership is the $100 purchase price. Assume that after the sale by A, the partnership sells the stock for $300 (at a time when the indexed basis is $240). The partnership recognizes $60 of gain and each partner takes into account $20 gain and makes the same adjustments as in the above example. If partner D then sold his partnership interest for $100, he will recognize a loss of $20 ($100 amount realized less adjusted basis for purposes of determining loss of $120; the $30 inflation adjustment would be disregarded in computing D's adjusted basis in his partnership interest.)

Example 3.—Same facts as in Example 2, except that the partnership has an election under section 754 in effect. When A sells his partnership interest to D, A recognizes $20 of gain, because under the bill, A's share of the partnership indexing adjustment is available to A at that time. Upon the sale of the stock by the partnership, D recognizes no gain or loss since the adjustment under section 743(b) had been made with respect to his share of the partnership properties. No adjustment is made by D to the basis in his partnership interest as a result of the sale by the partnership.

Foreign corporations

Common stock of a foreign corporation generally is an indexed asset if the stock is regularly traded on an established securities market. The Committee intends that the terms "regularly traded" and "established securities market" have the same meaning under the bill as they have in Treas. Reg. 1.884–5(d). Indexed assets, however, do not include stock in a foreign investment company, a passive foreign investment company (including a qualified electing fund), a foreign personal holding company, or, in the hands of a shareholder who meets the requirements of section 1248(a)(2) (generally pertaining to 10-percent shareholders of controlled foreign corporations), any other foreign corporation. An American Depository Receipt (ADR) for common stock in a foreign corporation is treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally is indexed.

Other rules

Improvements and contributions to capital

No indexing is provided for improvements or contributions to capital if the aggregate amount of the improvements or contributions to capital during the taxable year with respect to the property or stock is less than $1,000. If the aggregate amount of such improvements or contributions to capital is $1,000 or more, each addition is treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period

No indexing adjustment is allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction entered into by the taxpayer, or a related party.

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of three years, the provision requires that the amount realized be indexed for inflation for the short sale period.

Related parties

The bill does not index the basis of property for sales or dispositions between related persons, except to the extent the adjusted basis of property in the hands of the transferee is a substituted basis (e.g., gifts).

Collapsible corporations

Under the bill, indexing does not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under sec. 341) with respect to a distribution or sale of stock.

Effective Date

The provision applies to property the holding period of which begins after December 31, 2000.

A taxpayer holding any indexed asset on January 1, 2001, may elect to treat the indexed asset as having been sold on such date for an amount equal to its fair market value, and as having been reacquired for an amount equal to such value. If the election is made, the asset would be eligible for indexing under the provision. Any gain resulting from the election would be treated as received on the date of the deemed sale, and would not be treated as gain from the sale or exchange of property between related persons under Code section 1239. Any loss would not be allowed (and the disallowed loss would not be added to the basis of the indexed asset). For readily traded securities, fair market value is the closing market price on the business day following January 1, 2001. For this purpose, "readily traded" means readily tradable on an established securities market or otherwise.

A taxpayer may make the above election with respect to some indexed assets and not with respect to others.

3. Exclusion of gain on sale of principal residence (sec. 313 of the bill and secs. 121 and 1034 of the Code)

Present Law

Rollover of gain

No gain is 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 is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion

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

Reasons for Change

Calculating capital gain from the sale of a principal residence is 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 pay 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, detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades. To claim the exclusion, many taxpayers must determine the basis of each home they have owned, and appropriately adjust the basis of their current home to reflect any untaxed gains from previous housing transactions. This determination may involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face 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 leads to errors in the calculation of capital gains, and hence to an under- or overpayment of the capital gains on principal residences. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house.

To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision of present law encourages 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 promotes an inefficient use of taxpayer's financial resources.

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

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

Explanation of Provision

Under the bill 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 bill 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.

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 bill 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 $500,000 of gain on their joint return.

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

Effective Date

The provision is available for all sales or exchanges of a principal residence occurring on or after May 7, 1997, and replaces the present-law rollover and one-time exclusion provisions applicable to principal residences.

A taxpayer could elect to apply present law (rather than the new exclusion) to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on the 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.

4. 30-percent corporate alternative tax for certain capital gains (sec. 321 of the bill and sec. 1201 of the Code)

Present Law

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to tax at graduated rates up to 35 percent.

Reasons for Change

The Committee believes it is important that tax policy be conducive to economic growth. Economic growth cannot occur without saving, investment, and the willingness of businesses to take risks and exploit new market opportunities. The greater the pool of savings, the greater the monies available for business investment in equipment and research. It is through such investment in equipment and new products and services 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 Committee observes that net business saving has not increased significantly from its levels of a decade ago. The Committee believes that a lower rate of tax on capital gains will encourage investment, saving, and risk-taking, create new jobs, and promote economic growth.

Explanation of Provision

The bill provides a maximum rate of tax on the net capital gain of a corporation to the extent the gain is attributable to the sale or exchange of property held more than 8 years. The alternative tax is 32 percent on gain attributable to calendar year 1998; 31 percent on gain attributable to calendar year 1999; and 30 percent on gain attributable to calendar years after 1999. The bill also modifies the application of the corporate alternative capital gains tax so that the alternative capital gains tax applies to the lesser of 8-year gain or taxable income. Gain from the disposition of a collectible or attributable to the depreciation of section 1250 property is not eligible for the lower rate.

Effective Date

The provision applies to taxable years ending after December 31, 1997. However, the lower rate does not apply to amounts properly taken into account before January 1, 1998. For fiscal years beginning in 1998 and 1999, the tax is computed by applying the applicable percentage to the 8-year gain for the first portion of the year (or, if less, the 8-year gain for the entire year), but in an amount not to exceed the taxable income for the entire year and then by applying the applicable percentage to an amount equal to the 8-year gain for the entire year (or, if less, taxable income) reduced by the amount taxed at the applicable percentage for the first portion of the year.

In the case of gain taken into account by a corporation from a pass-through entity (i.e., a RIC, a REIT, an S corporation, a partnership, an estate or trust, or a common trust fund), the date taken into account by the entity is the appropriate date for applying the rule in the preceding paragraph.

IV. Alternative Minimum Tax Provisions

A. INCREASE EXEMPTION AMOUNT APPLICABLE TO INDIVIDUAL ALTERNATIVE MINIMUM TAX (SEC. 401 OF THE BILL AND SEC. 55 OF THE CODE)

Present Law

Present law imposes a minimum tax on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. This alternative minimum tax is imposed upon individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of $175,000. The exemption amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount. These threshold amounts are $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation.

Reasons for Change

The Committee is concerned about the projected trend that significantly more individuals with few or no tax preferences and adjustments will become subject to the alternative minimum tax in the near future. This trend is projected, in part, because the exemption amounts applicable to the individual alternative minimum tax are not indexed for inflation, while the standard deduction, personal exemptions, rate brackets and other features of the regular tax are indexed for inflation.

Explanation of Provision

For taxable years beginning in 1999, 2001, 2003, 2005 and 2007, the exemption amounts of the individual alternative minimum tax are increased as follows for each such year: (1) by $1,000 in the case of married individuals filing a joint return and surviving spouses; (2) by $750 in the case of other unmarried individuals; and (3) by $500 in the case of married individuals filing a separate return. For taxable years beginning after 2007, the exemption amounts are indexed for inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1998.

B. REPEAL ALTERNATIVE MINIMUM TAX FOR SMALL BUSINESSES AND REPEAL THE DEPRECIATION ADJUSTMENT (SECS. 402 AND 403 OF THE BILL AND SECS. 55 AND 56 OF THE CODE)

Present 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 relates to depreciation. In computing AMTI, depreciation on property placed in service after 1986 must be 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.

If a taxpayer is subject to alternative minimum tax in one year, such amount of tax is allowed as a credit in a subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year. If the taxpayer is an individual, this credit is allowed to the extent the taxpayer's alternative minimum tax liability is a result of adjustments that are timing in nature.

Reasons for Change

The Committee believes that the alternative minimum tax inhibits capital formation and business enterprise and is administratively complex. Therefore, the bill deletes the depreciation adjustment for new investment in depreciable property by all businesses and completely repeals the corporate alternative minimum tax for small businesses.

Explanation of Provision

Repeal of the corporate alternative minimum tax for small businesses

The corporate alternative minimum tax is repealed for small business 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, 1994, is a small business corporation for any 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 business corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million. A corporation that fails to meet the $7.5 million gross receipts test will become subject to corporate alternative minimum tax only with respect to preferences and adjustments that relate to transactions and investments entered into after the corporation loses its status as a small business corporation.

In addition, the alternative minimum tax credit allowable to a small business corporation may not exceed the corporation's regular tax liability (reduced by other credits) over 25 percent of the corporation's regular tax (reduced by foreign tax credits) in excess of $25,000.

Repeal of the depreciation adjustment

The alternative minimum tax adjustment relating to depreciation is repealed for all taxpayers for property placed in service after December 31, 1998.

Effective Date

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

C. REPEAL INSTALLMENT METHOD ADJUSTMENT FOR FARMERS (SEC. 404 AND SEC. 56 OF THE CODE)

Present 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 include 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 Committee understands that the Internal Revenue Service ("IRS") takes the position that the installment method may not be used for sales of property produced on a farm for alternative minimum tax purposes. The Committee further understands that the IRS has 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.[29] The Committee believes that this issue should be clarified in favor of the farmer.

Explanation of Provision

The bill generally provides that for purposes of the alternative minimum tax, farmers may use the installment method of accounting.

Effective Date

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

Title V. Estate, Gift, and Generation-Skipping Tax Provisions

A. ESTATE AND GIFT TAX PROVISIONS

1. Increase in estate and gift tax unified credit (sec. 501(a) of the bill and sec. 2010 of the Code)

Present Law

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.[30] A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is 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)).[31]

Reasons for Change

The Committee believes that increasing the amount of the estate and gift tax unified credit will encourage saving, promote capital

[29] Notice 97–13, January 28, 1997.

[30] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

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

formation and entrepreneurial activity, and help to preserve existing family-owned farms and businesses. The Committee further believes that indexing the unified credit exemption equivalent amount for inflation is appropriate to reduce the transfer tax consequences that result from increases in asset value attributable solely to inflation.

Explanation of Provision

The bill 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 2007. The increase in the effective exemption is phased in according to the following schedule: the effective exemption is $650,000 for decedents dying and gifts made in 1998; $750,000 in 1999; $765,000 in 2000; $775,000 in 2001 through 2004; $800,000 in 2005; $825,000 in 2006; $1 million in 2007. After 2007, the effective exemption is indexed annually for inflation. The indexed exemption amount 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, (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 provision is effective for decedents dying, and gifts made, after December 31, 1997.

2. Indexing of certain other estate and gift tax provisions (sec. 501(b)–(e) of the bill and sec. 2032A, 2503, 2631, and 6601(j) of the Code)

Present Law

Annual exclusion for gifts.—A taxpayer may 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 is $750,000.

Generation-skipping transfer ("GST") tax.—An individual is 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 is eligible for a special 4-percent interest rate (sec. 6601(j)).

Reasons for Change

The Committee believes that it is appropriate to index 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, to reduce the transfer tax consequences that result from increases in asset value attributable solely to inflation.

Explanation of Provision

The bill 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, 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. 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.

Effective Date

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

3. Installment payments of estate tax attributable to closely held businesses (secs. 502 and 503 of the bill and secs. 6601(j) and 6166 of the Code)

Present 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 section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business.

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 Committee believes that the installment payment provisions need to be expanded in order to better address the liquidity problems of estates holding farms and closely held businesses, to prevent the liquidation of such businesses in order to pay estate taxes. The Committee further believes that the protection of closely held businesses will preserve jobs and strengthen the communities in which such businesses are located.

In addition, by eliminating the deductibility of interest paid on estate taxes deferred under section 6166 (and reducing the interest rate accordingly), the bill eliminates 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 bill extends the period for which Federal estate tax installments can be made under section 6166 to a maximum period of 24 years. If the election is made, the estate pays only interest for the first four years, followed by up to 20 annual installments of principal and interest.

In addition, the bill provides that no interest 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). Thus, for example, in 1998, when the unified credit is increased to provide an effective exemption of $650,000 (as described above), the amount of estate tax attributable to the value of the closely held business between $650,000 and $1,650,000 is eligible for the zero-percent interest rate.

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. The interest paid on estate taxes deferred under section 6166 is not deductible for estate or income tax purposes.

Effective Date

The provision is effective for decedents dying after December 31, 1997.

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

Present 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)).

Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use under section 2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results 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 Committee believes that cash leasing of farmland among family members is 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 bill 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.

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

Present 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 present law, there is limited access to judicial review of disputes regarding initial or continuing eligibility for the deferral and installment election under section 6166. If the Commissioner determines that an estate was not initially eligible for deferral under section 6166, or has lost its eligibility for such deferral, the estate is 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 bill gives taxpayers 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 provision authorizes the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

Effective Date

The provision applies to decedents dying after date of enactment.

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

Present 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 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.

Most courts have 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 bill 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 after the date of enactment, the bill 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 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). It is also 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.

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. The extension of the special rule under chapter 14 to all gifts applies to gifts made in calendar years after the date of enactment.

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

Present 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[32] 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 beneficiaries. 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 section 644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, section 644 treats 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 accumulation distributions from a foreign trust than to accumulation distributions from domestic trusts. If a foreign trust accumulates income, changes its situs so as to become a domestic trust, and then makes

[32] 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.

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 are 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 Committee has determined that the insignificant potential tax reduction available through the transfer of property to trust no longer warrants the complexity of the throwback rules and section 644.

Explanation of Provision

The bill exempts from the throwback rules amounts distributed by a domestic trust after the date of enactment. The provision 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).

The treatment of foreign trusts, including the treatment of foreign trusts that become domestic trusts,[33] remains unchanged.

Effective Date

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

8. Unified credit of decedent increased by unified credit of spouse used on split gift included in decedent's gross estate (sec. 508 of the bill and sec. 2010 of the Code)

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during lifetime and at death. The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax. Under section 2513, one spouse can elect to treat a gift made by the other

[33] Rev. Rul. 91–6, 1991–1 C.B. 89.

spouse to a third person as made one-half by each spouse (i.e., "gift-splitting").

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer and then subtracting any transfer taxes payable for prior taxable periods. This amount is reduced by any remaining available unified credit (and other applicable credits) to determine the estate tax liability. The estate tax is imposed on all of the assets held by the decedent at his death, including the value of certain property previously transferred by the decedent in which the decedent had certain retained powers or interests. In such circumstances, property that has been treated as a gift made one-half by each spouse may be includible in both spouses' estates.

Reasons for Change

The ability to gift-split is intended to equalize the treatment of spouses in community property States and non-community property States. Gift-splitting effectively permits the transferor taxpayer to benefit from, among other things, any unified credit allowable to the non-transferor spouse. The benefit of the non-transferor spouse's unified credit is lost, however, in circumstances where the split-gift property is subsequently included in both spouses' estates. The Committee believes that it is inappropriate that the benefit of the non-transferor spouse's unified credit be lost in such circumstances.

Explanation of Provision

With respect to any split-gift property that is subsequently includible in both spouses' estates, the bill increases the unified credit allowable to the decedent's estate by the amount of the unified credit previously allowed to the decedent's spouse with respect to the split gift.

Effective Date

The provision applies to gifts made after the date of enactment.

9. Reformation of defective bequests to spouse of decedent (sec. 509 of the bill and secs. 2056(b) and 2523 of the Code)

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. However, "terminable interest" property (i.e., an interest in property that will terminate or fail) transferred to a spouse generally will only qualify for the marital deduction under certain special rules designed to ensure that there will be an estate or gift tax to the transferee spouse on unspent transferred proceeds. Thus, the effect of a marital deduction with the terminable interest rule is to provide only a method of deferral of the estate or gift tax, not exemption. One of the special terminable interest rules (Code sec. 2056(b)(5)) provides that the marital deduction is allowed where the decedent transfers property to a trust that is required to pay income to the surviving spouse and the surviving spouse has a general power of appointment at that spouse's death (under this so-called "power of appointment trust," the power of appointment both provides the surviving spouse with power to control the ultimate disposition of the trust assets and assures that the trust assets will be subject to estate or gift tax). Another special terminable interest rule called the "qualified terminable interest property" rule ("QTIP") generally permits a marital deduction for transfers by the decedent to a trust that is required to distribute all of the income to the surviving spouse at least annually and an election is made to subject the transferee spouse to transfer tax on the trust property. To qualify for the marital deduction, a power of appointment trust or QTIP trust must meet certain specific requirements. If there is a technical defect in meeting those requirements, the marital deduction may be lost.

Reasons for Change

The IRS generally has required strict compliance with the requirements for a qualified power of appointment trust under section 2056(b)(5) or for QTIP under section 2056(b)(7). As a result, taxpayers have been unable to qualify for the marital deduction due to inadvertent or unavoidable failure to meet those requirements. Accordingly, the Committee believes it is appropriate to provide a reformation procedure to allow such failures to be cured in order that the marital deduction not be lost.

Explanation of Provision

The bill allows the marital deduction with respect to a defective power of appointment or QTIP trust if there is a "qualified reformation" of the trust that corrects the defect. In order to qualify, the reformation must change the governing instrument in a manner that cures the defects to qualification of the trust for the marital deduction. In addition, where a reformation proceeding is commenced after the due date for the estate tax return (including extensions), the reformation would qualify only if, prior to reformation, the governing instrument provides (1) that the surviving spouse is entitled to all of the income from the property for life, and (2) no person other than the surviving spouse is entitled to any distributions during the surviving spouse's life. With respect to QTIP, an election to qualify must be made by the executor on the estate tax return as required by section 2056(b)(7)(B)(v).

The determination of whether a marital deduction should be allowed (i.e., the reformation has cured the defects to qualification and otherwise qualifies under this provision) is made either as of the due date for filing the estate or gift tax return (including any extensions) or the time that changes are completed pursuant to a reformation proceeding. The statute of limitations is extended with respect to the estate or gift tax attributable to the trust property until one year after the date the Treasury Department is notified that a qualified reformation has been completed or that the reformation proceeding has otherwise terminated.

Effective Date

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

B. GENERATION-SKIPPING TAX PROVISIONS

1. Severing of trusts holding property having an inclusion ratio of greater than zero (sec. 511 of the bill and sec. 2642(a) of the Code)

Present Law

A generation-skipping transfer tax ("GST" tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. An exemption of $1 million is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

If the value of the transferred property exceeds the amount of the GST exemption allocated to that property, the GST tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (i.e., currently 55 percent) by the "inclusion percentage" and the value of the taxable property at the time of the taxable event. The "inclusion percentage" is the number one minus the "exclusion percentage". The exclusion percentage generally is calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.

Under Treasury regulations, trusts that are included in the transferor's gross estate or created under the transferor's will may be validly severed only if (1) the trust is severed according to a direction in the governing instrument; or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Treas. Reg. 26.2654-1(b).

Reasons for Change

The Committee believes it is appropriate to provide flexibility for the severance of trusts to minimize the need for complicated governing documents and to remove a potential trap for poorly advised taxpayers. The Committee understands that a similar result can already be obtained by creating separate trusts in the governing document. The flexibility of a severance should only be afforded, however, in situations where the Treasury Department believes there is no significant opportunity for tax avoidance as a result of the severance.

Explanation of Provision

If a trust with an inclusion ratio of greater than zero is severed into two separate trusts, the bill allows the trustee to elect to treat one of the separate trusts as having an inclusion ratio of zero and the other separate trust as having an inclusion ratio of one. To qualify for this treatment, the separate trust with the inclusion ratio of one must receive an interest in each property held by the single trust (prior to severance) equal to the single trust's inclusion ratio, except to the extent otherwise provided by regulation. The remaining interests in each property will be transferred to the separate trust with the inclusion ratio of zero. The election must be irrevocable, and must be made at a time and in a manner prescribed by the Treasury Department.

Effective Date

The provision is effective for severances of trusts occurring after the date of enactment.

2. Modification of generation-skipping transfer tax for transfers to individuals with deceased parents (sec. 512 of the bill and sec. 2651 of the Code)

Present 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)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Reasons for Change

The Committee believes 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 Committee believes 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 Committee also understands that this treatment will remove a present law impediment to the establishment of charitable lead trusts.

Explanation of Provision

The bill 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 would apply 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 bill 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.

Title VI. Extension of Certain Expiring Tax Provisions

A. RESEARCH TAX CREDIT (SEC. 601 OF THE BILL AND SEC. 41 OF THE CODE)

Present Law

General rule

Section 41 provides 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 will not apply to amounts paid or incurred after May 31, 1997.[34]

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

[34] 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).

(so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[35]

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change 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.

[35] 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-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified 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)).

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").[36]

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

[68] 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.

year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Reasons for Change

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

Explanation of Provision

The research tax credit is extended for 19 months—i.e., generally for the period June 1, 1997, through December 31, 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

The provision generally is effective for qualified research expenditures paid or incurred during the period June 1, 1997, through December 31, 1998.

A special rule provides that, notwithstanding the general termination date for the research credit of December 31, 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 30-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 19-month extension provided for by this bill. However, to prevent taxpayers from effectively obtaining more than 30-months of research credits from the Small Business Job Protection Act of 1996 and this bill, the 30-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.

B. CONTRIBUTIONS OF STOCK TO PRIVATE FOUNDATIONS (SEC. 602 OF THE BILL AND SEC. 170(e)(5) OF THE CODE)

Present 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.[37] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[38]

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.[39] 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 did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Reasons for Change

The Committee believes 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 bill extends the special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through December 31, 1998.

Effective Date

The provision is effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through December 31, 1998.

[37] 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)).

[38] 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).

[39] 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 BILL 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. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

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

The deduction for wages is reduced by the amount of the credit. Also, the credit does not reduce alternative minimum tax (AMT) liability.

Targeted groups eligible for the credit

(1) Families receiving AFDC

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

(2) Qualified ex-felon

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

(3) High-risk-youth

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

(4) Vocational rehabilitation referral

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

(5) Qualified summer youth employee

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

(6) Qualified Veteran

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

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

(7) Families receiving Food Stamps

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

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 or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Reasons for Change

The Committee believes that this short-term 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.

Explanation of Provision

The bill extends for one year the work opportunity tax credit and makes four modifications: (1) the minimum employment period is reduced to 120 hours, (2) the credit percentage is modified so that the percentage is 25% for the first 400 hours and 40% thereafter (assuming the minimum employment period is satisfied with respect to that employee), (3) an otherwise eligible member of a family receiving AFDC benefits satisfies the credit requirements if the family has received AFDC benefits for any 9-month period during the 18-month period ending on the hiring date (this expansion applies whether or not the individual is a qualified veteran), and (4) the credit is allowed against the AMT.

Effective Date

Generally the provisions that extend the work opportunity tax credit and make other modifications to the credit are effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before October 1, 1998. The provision allowing the credit against the AMT is effective for taxable years beginning after December 31, 1997.

D. ORPHAN DRUG TAX CREDIT (SEC. 604 OF THE BILL AND SEC. 45C OF THE CODE)

Present Law

A 50-percent nonrefundable tax credit is 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 does not apply to expenses paid or incurred after May 31, 1997.[40]

Reasons for Change

In order to encourage the socially optimal level of research to develop drugs to treat rare diseases and conditions—and because the research and clinical testing of such drugs often must be conducted over several years—the Committee believes that the orphan drug tax credit should be permanently extended.

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.

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

TITLE VII. DISTRICT OF COLUMBIA TAX INCENTIVES

(SECS. 701–702 OF THE BILL AND NEW SECS. 1400–1400D OF THE CODE)

Present Law

Empowerment zones and enterprise communities

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.[41] 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). Portions of the District of Columbia were designated as an enterprise community.

The following tax incentives are available for certain businesses located in empowerment zones: (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" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,000 of expensing for 1997; the allowable amount will increase to $38,500 for 1998); 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 will be available during the period that the designation remains in effect, i.e., a 10-year period.

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), 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 prop-

[41] 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), an Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

erty 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 the greater of 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000.

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (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' tangible property is used within a zone or community; (4) substantially all of the business' 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 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.

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.[42] 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. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is 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) the principal user of which is an

[42] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

"enterprise zone business" (also defined above[43]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community. These bonds may only be issued while an 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.

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 the maximum rate of tax is limited to 28 percent of the net capital gain.[44] 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.

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.

Individual tax rates

To determine tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules

[43] For purpose of the tax-exempt financing rules, and "enterprise zones Business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

[44] The Revenue Reconciliation Act of 1993 added Code section 12002, which 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.

apply based on an individual's filing status. For 1997, the individual income tax rate schedules are as follows:

If taxable income is	Then income tax equals
Single individuals	
$0–$24,650	15 percent of taxable income.
$24,651–$59,750	$3,698, plus 28% of the amount over $24,650.
$59,751–$124,650	$13,526, plus 31% of the amount over $59,750.
$124,651–$271,050	$33,645, plus 36% of the amount over $124,650.
Over $271,050	$86,349, plus 39.6% of the amount over $271,050.
Heads of households	
$0–$33,050	15 percent of taxable income.
$33,051–$85,350	$4,958, plus 28% of the amount over $33,050.
$85,351–$138,200	$19,602 plus 31% of the amount over $85,350.
$138,201–$271,050	$35,985, plus 36% of the amount over $138,200.
Over $271,050	$83,811, plus 39.6% of the amount over $271,050.
Married individuals filing joint returns	
$0–$41,200	15 percent of taxable income.
$41,201–$99,600	$6,180, plus 28% of the amount over $41,200.
$99,601–$151,750	$22,532, plus 31% of the amount over $99,600.
$151,751–$271,050	$38,698, plus 36% of the amount over $151,750.
Over $271,050	$81,646, plus 39.6% of the amount over $271,050.
Married individuals filing separate returns	
$0–$20,600	15 percent of taxable income.
$20,601–$49,800	$3,090, plus 28% of the amount over $20,600.
$49,801–$75,875	$11,266, plus 31% of the amount over $49,800.
$75,876–$135,525	$19,349, plus 36% of the amount over $75,875.
Over $135,525	$40,823 plus 39.6% of the amount over $135,525.

Reasons for Change

The Committee believes that the District of Columbia faces two key problems—residents migrating from the District and insufficient economic activity. To this end, the Committee has provided certain tax incentives to reduce the Federal tax burden on certain District residents, and to encourage economic development in those areas of the District where development has been inadequate. However, the Committee is aware that the efficacy of tax incentives to address one or both problems is severely limited absent fundamental structural reform of the District's government and economy. Thus, the availability of the tax incentives is contingent on the passage of other Federal legislation that will implement such critical structural reforms.

Explanation of Provision

Designation of D.C. Enterprise Zone

Certain economically depressed census tracts within the District of Columbia are designated 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., portions 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 at least 35 percent. 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.[45]

The following tax incentives will take effect only if, prior to January 1, 1998, a Federal law is enacted creating a District of Columbia economic development corporation that is an instrumentality of the District of Columbia government.[46]

Business development incentives

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

The following tax incentives that are available under present law in empowerment zones would be 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 D.C. Enterprise Zone 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 general, the wage credit for certain D.C. Enterprise Zone residents who work in the D.C. Enterprise Zone is the same as is available in empowerment zones under present law. However, the wage credit rate remains at 20 percent for the D.C. Enterprise Zone for the period 1998 through 2002 (and does not phase down to 15 percent in the year 2002 as under present-law section 1396). The wage credit is effective for wages paid (or incurred) to a qualified individual after December 31, 1997, and before January 1, 2003.

The increased expensing under Code section 179 is effective for property placed in service in taxable years beginning after December 31, 1997, and before January 1, 2003. Thus, qualified D.C. Zone property placed in service in taxable years beginning in 1998 is eligible for up to $38,500 of expensing.

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

[46] In addition, the bill assumes the enactment of certain modifications to Federal law (other than Federal tax laws contained in the Internal Revenue Code) similar to those proposed by the Administration that would clarify and expand the District's authority to issue revenue bonds.

A qualified D.C. Zone business (defined as under present law section 1394(b)(3)) is permitted to borrow proceeds from the issuance of qualified enterprise zone facility bonds. Such bonds can be issued only by a newly created economic development corporation and are subject to the requirements applicable under present law to enterprise zone facility bonds, except that the amount of outstanding bond proceeds that can be borrowed by any qualified District business cannot exceed $15 million (rather than $3 million). The special tax-exempt bond provisions apply to bonds issued after December 31, 1997, and prior to January 1, 2003.

Tax credits for equity investments in and loans to businesses located in the District of Columbia

A newly created economic development corporation is authorized to allocate $75 million in tax credits to taxpayers that make certain equity investments in, or loans to, businesses (either corporations or partnerships) engaged in an active trade or business in the District of Columbia. The business need not be located in the D.C. Enterprise Zone, although factors to be considered in the allocation of credits include whether the project would provide job opportunities for low and moderate income residents of the D.C. Enterprise Zone and whether the business is located in the D.C. Enterprise Zone. Eligible businesses are not be required to satisfy the criteria of a qualified D.C. Zone business, described above. Such credits are nonrefundable and can be used to offset a taxpayer's alternative minimum tax (AMT) liability.

Under the bill, the amount of credit cannot exceed 25 percent of the amount invested (or loaned) by the taxpayer. Thus, the economic development corporation may allocate the full $75 million in tax credits to no less than $300 million in equity investments in, or loans, to eligible businesses.

Under the bill, credits may be allocated to loans made to an eligible business only if the business uses the loan proceeds to purchase depreciable tangible property and any functionally related and subordinate land. Credits may be allocated to equity investments only if the equity interest was acquired for cash. Any credits allocated to a taxpayer making an equity investment are subject to recapture if the equity interest is disposed of by the taxpayer within five years. A taxpayer's basis in an equity investment is reduced by the amount of the credit.

The bill applies to credit amounts allocated for taxable years beginning after December 31, 1997, and before January 1, 2003.[47]

Zero percent capital gains rate

The bill 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, D.C. Zone assets mean stock or partnership interests held in or tangible property held by a D.C. Zone business. For this purpose, a D.C. Zone business is defined as an enterprise zone business under present-law section 1397B.

[47] As a general business credit, the credit can be carried back three years (but not before January 1, 1998) and forward for fifteen years.

"D.C. Zone business stock" is stock in a domestic corporation originally issued after December 31, 1997, that, at the time of issuance[48] and during substantially all of the taxpayer's holding period, was a D.C. Zone business, provided that such stock was acquired by the taxpayer on original issue from the corporation solely in exchange for cash[49]. 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[50] and during substantially all of the taxpayer's holding period, the partnership was a D.C. Zone business. Finally, "D.C. Zone business property" is tangible property acquired by the taxpayer by purchase (within the meaning of present law section 179(d)(2)) after December 31, 1997, and before January 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 D.C. Zone business of the taxpayer.

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. 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. Thus, substantially renovated real estate located in the D.C. Enterprise Zone may constitute D.C. Zone business property. However, the bill specifically excludes land that is not an integral part of a D.C. Zone business from the definition of D.C. Zone business property.

In addition, qualified D.C. Zone assets include property that was a qualified D.C. Zone asset in the hands of a prior owner, 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 D.C. Zone business, or (2) the property is an ownership interest in a D.C. Zone business.[51]

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 attributable to periods before December 31, 1997, and after December 31, 2007, is not qualified capital

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

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

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

[51] 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.

gain. No gain attributable to real property, or an intangible asset, which is not an integral part of a D.C. Zone business qualifies for the zero percent rate.

The bill 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 D.C. Zone business after the five-year period beginning on the date the taxpayer acquired such property would continue to be treated as a 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.

Special rules are provided for pass-through entities (i.e., partnerships, S corporations, regulated investment companies, and common trust funds). In the case of a sale or exchange of an interest in a pass-through entity that was not a D.C. Zone business during substantially all of the period that the taxpayer held the interest, the zero percent capital gains rate applies to the extent that the gain is attributable to amounts that would have been qualified capital gain had the assets been sold for their fair market value on the date of the sale or exchange of the interest in the pass-through entity. This rule applies only if the interest in the pass-through entity were held by the taxpayer for more than five years. In addition, the rule applies only to qualified D.C. Zone assets that were held by the pass-through entity for more than five years, and throughout the period that the taxpayer held the interest in the pass-through entity.

The bill 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.

Individual resident tax rate reduction

Individuals who have their principal place of abode in any census tract that is part of the D.C. Enterprise Zone are entitled to a 10-percent tax rate on all taxable income that currently is subject to a 15-percent Federal income tax rate. Thus, using the 1997 tax rate schedule, a single taxpayer who resides in the D.C. Enterprise Zone with $24,650 or more of taxable income will receive a Federal income tax reduction of $1,233 under the bill. Married taxpayers who reside in the D.C. Enterprise Zone and file a joint return with taxable income of $41,200 or more of taxable income will receive a Federal income tax reduction of $2,060 under the bill.

The special 10-percent rate provision is in effect for the period 1998–2007.

Effective Date

The D.C. tax incentives generally are effective January 1, 1998, and remain in effect for five years until the termination of the D.C.

Enterprise Zone designation on December 31, 2002. However, the zero percent tax rate for capital gains and the special 10-percent rate bracket are effective for the period 1998–2007.

TITLE VIII. WELFARE-TO-WORK TAX CREDIT

(SEC. 801 OF THE BILL 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. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

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 Committee believes 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 bill provides to employers a 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% of the first $10,000 of eligible wages in the first year of employment and 50% 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 are 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 section 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.

TITLE IX. MISCELLANEOUS PROVISIONS

A. EXCISE TAX PROVISIONS

1. Repeal excise tax on diesel fuel used in recreational motorboats (sec. 901 of the bill and secs. 4041 and 6427 of the Code)

Present Law

Before a temporary suspension through December 31, 1997 was enacted in 1996, diesel fuel used in recreational motorboats was subject to the 24.3-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

Many marinas have found it uneconomical to carry both undyed (taxed) and dyed (untaxed) diesel fuel because the majority of their market is for uses not subject to tax. As a result, some recreational boaters have experienced difficulty finding fuels. In 1996, Congress suspended imposition of the tax on recreational boating while alternative collection methods were evaluated. No satisfactory alternative has been found; therefore, the Committee 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 provision 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.

2. Continued application of tax on imported recycled Halon-1211 (sec. 902 of the bill and sec. 4682 of the Code)

Present Law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is $6.25 per pound in 1997 and will increase by 45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are 3 for halon-1211, 10 for halon-1301, and 6 for halon-2402.

Taxable chemicals that are recovered and recycled within the United States are exempt from tax. 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 Committee understands 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 Committee believes permitting imported recycled halon-1211 to compete in the market tax free may destroy this entrepreneurial and environmental success story.

Explanation of Provision

The bill repeals the present-law exemption for imported recycled halon-1211.

Effective Date

The provision is effective on the date of enactment.

3. Uniform rate of excise tax on vaccines (sec. 903 of the bill and secs. 4131 and 4132 of the Code)

Present Law

Under section 4131, a manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: 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 is administered by combining more than one of the listed taxable vaccines, the amount of tax imposed is 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 is 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. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1998, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Reasons for Change

The Committee understands that the present-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 Committee understands 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 Committee believes some simplicity can be achieved by taxing such vaccines at the same rate per dose.

The Committee further believes it is 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 (hemophilus influenza type B), Hepatitis B, and varicella (chickenpox) be widely administered among the nation's children. In light of the growing number of immunizations using these vaccines, the Committee adds these vaccines to the list of taxable vaccines.

Explanation of Provision

The bill replaces the present-law excise tax rates, that differ by vaccine, with a single rate tax of $0.84 per dose on any listed vaccine component. Thus, the bill provides that the tax applied to any vaccine that is a combination of vaccine components is 84 cents times the number of components in the combined vaccine. For example, the MMR vaccine is to be taxed at a rate of $2.52 per dose and the DT vaccine is to be taxed at rate of $1.68 per dose.

In addition, the provision adds three new taxable vaccines to the present-law taxable vaccines: (1) HIB (hemophilus influenza type B); (2) Hepatitis B; and (3) varicella (chickenpox). The three newly listed vaccines also are subject to the 84-cents per dose excise tax.

Effective Date

The provision is effective for vaccine purchases after September 30, 1997. No tax is to be collected or refunds permitted for amounts held for sale on October 1, 1997.

4. Treat certain gasoline "chain retailers" as wholesale distributors under the gasoline excise tax refund rules (sec. 904 of the bill and sec. 6416 of the Code)

Present Law

Gasoline is taxed at 18.3 cents per gallon upon removal from a registered pipeline or barge terminal facility. 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. Retailers do not qualify as wholesale distributors, regardless of their size.

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 Committee determined that allowing 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 who own and 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 is effective after September 30, 1997.

5. Exemption of electric and other clean-fuel motor vehicles from luxury automobile classification (sec. 905 of the bill and secs. 4001 and 4003 of the Code)

Present Law

Present law imposes an excise tax on the sale of automobiles whose price exceeds a designated threshold, currently $34,000. The excise tax is imposed at a rate of 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 $34,000 threshold is indexed for inflation. The present-law index of $34,000 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 10-percent tax is imposed on the separate purchase of vehicle and parts and accessories therefor when the sum of the separate purchases exceeds the luxury tax threshold (sec. 4003).[52]

The tax under section 4001 applies to sales before January 1, 2003. The tax under section 4003 has no termination date.[53]

Reasons for Change

The Committee believes 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 Committee believes the cost of this technology should not be considered a luxury for the purpose of the luxury excise tax on automobiles. Therefore, the Committee believes it is 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 bill 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 (as defined under sec. 179A(c)(1)(A)), the threshold would be $30,000, as adjusted for inflation under present law, plus an amount equal to the increment

[52] The rate of tax under section 4003 is not determined by reference to section 4001. However, a technical correction under the bill (Title XV) conforms the tax rate applicable under section 4003 to that applicable under section 4001.

[53] A technical correction under the bill (Title XV) conforms the expiration date of the tax under section 4003 to the expiration date under section 4001.

to the retail value of the automobile attributable to the retrofit parts and components installed. For example, assume that in 1997, after the date of enactment, an individual purchases a clean-burning fuel vehicle for $43,000. Further assume that had the individual purchased the identical vehicle, without having had certain components replaced to qualify it as clean burning, the price paid would have been $39,000. The incremental increase in the price of the vehicle due to the installation of the qualified property is $4,000, and the luxury tax would be applied for the amount paid above a threshold of $38,000 (the $34,000 base threshold applicable for 1997 plus $4,000 for the value of the incremental components). The tax would apply to $5,000 of the sales price ($43,000 less the $38,000 threshold).

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.

For all other vehicles, the threshold remains equal to that provided under present law.

Effective Date

The provision is effective for sales and installations occurring on or after the date of enactment.

B. PROVISIONS RELATING TO PENSIONS AND OTHER BENEFITS

1. Cash or deferred arrangements for irrigation and drainage entities (sec. 911 of the bill and sec. 401(k) of the Code)

Present Law

Under present law, taxable and tax-exempt employers may maintain qualified cash or deferred arrangements. State and local government organizations generally are prohibited from establishing qualified cash or deferred arrangements (“section 401(k) plans”). This prohibition does not apply to 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 Committee believes 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 bill, 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.

2. Permanent moratorium on application of nondiscrimination rules to governmental plans (sec. 912 of the bill)

Present Law

Under present 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).

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. 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 Committee believes 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 bill provides that governmental plans will be exempt from the nondiscrimination and minimum participation rules.

Effective Date

The provision is effective for taxable years beginning on and after the date of enactment.

3. Treatment of certain disability payments to public safety employees (sec. 913 of the bill and sec. 104 of the Code)

Present Law

Under present 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. Nonoccupational death and disability benefits are not excludable from income as workmen's compensation benefits.

Reasons for Change

The Committee is 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 Committee believes it appropriate to provide relief in such cases.

Explanation of Provision

Under the bill, 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 bill 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 bill 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 is effective on the date of enactment.

1. Portability of permissive service credit under governmental pension plans (sec. 914 of the bill and sec. 415 of the Code)

Present Law

Under present 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 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.

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.

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 Committee believes it appropriate to modify the limits on contributions and benefits to encourage portability of benefits between governmental plans.

Explanation of Provision

Under the bill, in applying the defined benefit pension plan limit, the annual benefit under a State or local governmental plan includes the accrued benefit derived from contributions to purchase permissive service credit. Such contributions are not taken into account in determining annual additions.

Permissive service credit means credit for a period of service recognized by the governmental plan if the employee contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the accrued benefit attributable to such period of service.

The bill does not affect the treatment of "pick up" contributions.

Effective Date

The provision is effective with respect to years beginning after December 31, 1997.

5. Gratuitous transfers for the benefit of employees (sec. 915 of the bill and sec. 664 of the Code)

Present Law

Employee stock ownership plans

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. The securities, which are held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts).

Charitable remainder trusts

A deduction is allowed for Federal estate tax purposes for transfers by a decedent to charitable, religious, scientific, etc. organizations (Code sec. 2055(a)). In the case of a transfer of a remainder interest to a charity, the remainder interest must be in a charitable remainder trust (Code sec. 2055(e)). 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 the remainder of the trust (i.e., after termination of the annuity or unitrust amounts) to a charitable, religious, scientific, etc. organization (Code sec. 664).

Reasons for Change

The Committee believes it appropriate to encourage certain transfers of stock to an ESOP.

Explanation of Provision

In general

The bill 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 bill 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: (1) the securities transferred 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[54] 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 imposed 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.

[54] The 60-percent requirement is determined assuming that outstanding options have been exercised.

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 can not 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 bill applies to transfers made to trusts to, or for the use of, an ESOP after the date of enactment.

6. Treatment of certain transportation on noncommercially operated aircraft as a fringe benefit (sec. 916 of the bill and sec. 132 of the Code)

Present Law

Under present law, the value of an employer-provided flight taken for personal purposes is generally includible in income. However, under a special rule in regulations, the value of a personal flight is deemed to be zero (and, therefore, there is no income inclusion) if at least 50 percent of the regular passenger seating capacity of the aircraft is occupied by individuals whose flights are primarily for the employer's business (and therefore, excludable from income).

Reasons for Change

The Committee believes that the present-law rule for valuing flights on employer aircraft unfairly results in taxable income in certain cases.

Explanation of Provision

Under the provision, the value of air transportation for personal purposes is excludable from income if the flight is made in the ordinary course of the trade or business of an employer and the flight would have been made whether or not the employee was transported on the flight, and the employer incurs no substantial additional cost (including foregone revenue) in providing the flight to the employee.

Effective Date

The provision is effective for transportation services provided after December 31, 1998.

7. Cash out of certain accrued benefits (sec. 917 of the bill and secs. 411 and 417 of the Code)

Present Law

Under present 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 applicable, the consent of the participant's spouse) if the present value of the benefit does not exceed $3,500. 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.

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 Committee believes 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 bill increases the limit on involuntary cash-outs to $5,000 from $3,500. The $5,000 amount is adjusted annually for inflation beginning after 1997 (in $50 increments).

Effective Date

The provision is effective for plan years beginning on and after the date of enactment.

8. ESOPS maintained by S corporations (sec. 918 of the bill and secs. 409 and 4975 of the Code)

Present Law

Under present law, an S corporation can have no more than 75 shareholders. 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.

ESOPs are subject to certain prohibited transaction rules 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, including exceptions for loans between the plan and plan participants and certain sales of stock to the ESOP. These statutory exceptions do not apply to shareholder-employees of S corporations. However, such individuals can obtain an administrative exception from such rules from the Department of Labor.

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 bill provides that ESOPs of S corporations may distribute cash to plan participants. In addition, the bill extends the exception to certain prohibited transactions rules to S corporations.

Effective Date

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

C. DISASTER RELIEF PROVISIONS

1. Authority to postpone certain tax-related deadlines by reason of presidentially declared disaster (sec. 921 of the bill and new sec. 7508A of the Code)

Present 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 Committee believes that the Secretary should have the authority to postpone additional tax-related deadlines.

Explanation of Provision

The bill provides that, in the case of a taxpayer determined to be affected by a Presidentially declared disaster, the Secretary may specify that, for a period of up to 90 days, certain taxpayer deadlines are postponed. 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.

Effective Date

The provision is effective for any period for performing an act that has not expired before the date of enactment.

2. Use of certain appraisals to establish amount of disaster loss (sec. 922 of the bill and sec. 165 of the Code)

Present 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 Committee believes that no impediment should exist to utilizing alternate types of acceptable appraisals.

Explanation of Provision

The bill provides that nothing in the Code should 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 is effective on the date of enactment.

3. Treatment of livestock sold on account of weather-related conditions (sec. 923 of the bill and secs. 451 and 1033 of the Code)

Present 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). Consequently, 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 Committee believes 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 bill 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 bill 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.

4. Mortgage bond financing for residences located in Presidentially declared disaster areas (sec. 924 of the bill and sec. 143 of the Code)

Present 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 law waives the 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 Committee believes that availability of mortgage subsidy financing may help survivors of Presidentially declared disasters rebuild their homes.

Explanation of Provision

The bill waives the first time homebuyer requirement, the income limits, and the purchase price limits for loans to finance homes in certain Presidentially declared disaster areas. The waiver applies only during the one-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, 2000.

D. PROVISIONS RELATING TO EMPLOYMENT TAXES

1. Employment tax status of distributors of bakery products (sec. 931 of the bill and sec. 3121 of the Code)

Present Law

Under present law, the determination of whether a worker is an employee or an independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship generally exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished.

Under a special statutory rule, bakery distributors are treated as employees for Social Security payroll tax purposes (even if they are independent contractors for income tax purposes) if: (1) their services are part of a continuing relationship with the person for whom they are performed; (2) the distributor's service contract contemplates that he or she will perform substantially all of the services personally; and (3) the distributor does not have a substantial investment in facilities used in the performance of services, excluding facilities used for transportation. This provision also applies to distributors of meat, vegetable, fruit, and beverage (other than milk) products, as well as to distributors of laundry and dry cleaning services.

Bakery drivers generally take the position that they are not employees under the statutory rule because they have a substantial investment in facilities and their contract of service does not contemplate that substantially all services are to be performed personally by them.

Reasons for Change

The Committee believes that the special rule for determining employment status of bakery drivers is not consistent with the current practice of the industry and no longer necessary.

Explanation of Provision

The bill deletes distributors of bakery products from the list of product and service distributors treated as statutory employees for Social Security payroll tax purposes. Thus, the status of such workers is determined under the generally applicable rules.

Effective Date

The provision is effective for services performed after December 31, 1997.

2. Clarification of standard to be used in determining tax status of retail securities brokers (sec. 932 of the bill)

Present Law

Under present 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

Brokerage houses are required to monitor compliance with certain investor protection laws. The Committee believes that such monitoring should not be taken into account in determining the status of a broker for Federal tax purposes.

Explanation of Provision

Under the bill, 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.

3. Clarification of exemption from self-employment tax for certain termination payments received by former insurance salesmen (sec. 933 of the bill and sec. 1402 of the Code)

Present 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 a former insurance salesmen who had sold insurance as an independent contractor 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

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 bill 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 solely on policies sold by the individual during the last year of the agreement and 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.

The bill will also amend 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.

4. Safe harbor for independent contractors (sec. 934 of the bill and new sec. 3511 of the Code)

Present Law

Under present 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") has developed a set of 20 factors for use in applying the common-law test.

Under a special safe harbor rule (section 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. Section 530 does not apply to the worker and does not apply for income tax purposes. Section 530 does not apply to technical services personnel.

Reasons for Change

The present-law rules for determining worker status continue to generate controversies between taxpayers and the IRS. Because the determination of proper classification of a worker is often factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. The consequences of misclassification can be severe, particularly if the misclassification was inadvertent. The Committee believes that providing more specific rules for determining worker classification will provide greater clarity for taxpayers and reduce disputes with the IRS.

Explanation of Provision

In general

The bill provides a statutory safe harbor for determining worker classification for Federal tax purposes. If the standards set forth in the bill are met, the worker is not treated as an employee and the service recipient (or payor) is not treated as an employer. If the safe harbor is not satisfied, the determination of the worker's status is made under the present-law rules.

Standards for determining whether individuals are not employees

Under the bill, the following three sets of requirements have to be satisfied in order for a worker not to be treated as an employee: (1) worker requirements regarding the service recipient; (2) worker requirements regarding others; and (3) documentation requirements. The requirements regarding the worker are satisfied if, in connection with performing the services, the worker: (1) has a significant investment in assets and/or training; (2) incurs significant unreimbursed expenses; (3) agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause; (4) is paid primarily on a commissioned basis; or (5) purchases products for resale.

The requirements regarding others are satisfied if one of the following two requirements is met: (1) a place of business requirement; or (2) a services available to the public requirement. The place of business requirement is satisfied if the worker: (1) has a principal place of business; (2) does not primarily perform services in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business. The services available to the public requirement is satisfied if the worker is not required to perform services exclusively for the service recipient, and during the year (or the preceding or subsequent year) the worker (1) has performed a significant amount of services for other persons; (2) has offered to perform services for other persons through advertising, individual written or oral solicitations, listings with agencies, brokers, or other organizations that provide referrals, or other similar activities; or (3) provides service under a business name that is registered with (or licensed by) a State or a political subdivision (or an agency or instrumentality of a State or political subdivision).

The documentation requirements are satisfied if the services performed by the worker are performed pursuant to a written contract between the worker and the service recipient (or payor) and the contract provides that the worker will not be treated as an employee.

If the service recipient (or payor) fails to file the appropriate Federal tax returns (including information returns) with respect to a worker for a taxable year, the safe harbor is not available for such year. Thus, the classification of the worker for the year is determined under the present-law rules.

If the worker performs services through an entity owned in whole or in part by the worker, then the standards under the bill may be applied to include the entity as the worker. The term service recipient (and payor) does not include any entity which is owned in whole or in part by the worker. Thus, the new standards do not apply to the relationship between the worker and an entity if the worker has any ownership interest in the service recipient (or payor) (e.g., if the worker provides services through a personal service corporation, the bill does not apply with respect to the relationship between the worker and the personal service corporation).

Effective Date

The provision is effective with respect to services performed after December 31, 1997.

E. PROVISIONS RELATING TO SMALL BUSINESS

1. Delay imposition of penalties for failure to make payments electronically through EFTPS until after December 31, 1998 (sec. 941 of the bill and sec. 6302 of the Code)

Present 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)[55]). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[56] Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS

[55] This requirement was enacted in 1993 (sec. 523 of P.L. 103–182).

[56] 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.

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 had 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.[57] 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[58] 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 Committee believes 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 bill provides that no penalty shall be imposed solely by reason of a failure to use EFTPS prior to January 1, 1999, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Effective Date

The provision is effective on the date of enactment.

2. Home office deduction: clarification of definition of principal place of business (sec. 942 of the bill and sec. 280A of the Code)

Present 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

[57] Sec. 1809 of P.L. 104–188.

[58] IR–97–32.

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)).[59] 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.[60] Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not 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)).

[59] 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,* (1990) T.C. Memo 1990–483.

[60] 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.

Reasons for Change

The Committee believes that the Supreme Court's decision in *Soliman* unfairly denies 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 Committee will reduce the present-law bias in favor of taxpayers who manage their business activities from outside their home, 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 bill, 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 bill. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still will be 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 bill 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, 1997.

F. OTHER PROVISIONS

1. Shrinkage for inventory accounting (sec. 951 of the bill and sec. 471 of the Code)

Present Law

Section 471(a) provides that "(w)henever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine 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.[61] 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*,[62] the U.S. Tax Court held that a taxpayer's method of accounting may

[61] Treas. reg. sec. 1:471–2(d).

[62] 101 T.C. 462 (1993).

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,*[63] 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[64] 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 Committee believes that inventories should be kept in a manner that clearly reflects income. The Committee also believes 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 Committee believes that income will be more clearly reflected if the taxpayer makes a reasonable estimate of the shrinkage occurring through year-end, rather than simply ignoring it.

The Committee believes 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. The Committee does not believe that it is appropriate to deny a taxpayer access to such a method solely because its current, acceptable method of accounting does not utilize shrinkage estimates.

Explanation of Provision

The bill 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.

Effective Date

The provision is effective for taxable years ending after the date of enactment.

[63] T.C. Memo (filed June 11, 1997).

[64] *Wal-Mart* v. *Commissioner,* T.C. Memo 1997–1 and *Kroger* v. *Commissioner,* T.C. Memo 1997–2.

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. Such a change is treated as a voluntary change 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. 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 by the Committee by the adoption of this provision with regard to the validity of any method of accounting for inventories under present law.

2. Treatment of workmen's compensation liability under rules for certain personal injury liability assignments (sec. 952 of the bill and sec. 130 of the Code)

Present 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 law provides 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 a qualified assignment under section 130 does 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 Committee understands that some workmen's compensation payments involve periodic payments (rather than lump sum payments). The Committee 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 is 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 provision 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.

3. Tax-exempt status for certain State workmen's compensation act companies (sec. 953 of the bill and sec. 501(c)(27) of the Code)

Present 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 social welfare organizations or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. However, the IRS may be reluctant to rule that particular State risk-pooling entities satisfy the section 501(c)(4) or 115 requirements for tax-exempt status.

Reasons for Change

The Committee believes that eliminating uncertainty concerning the eligibility of certain State workmen's compensation act companies for tax-exempt status will assist States in ensuring workmen's compensation coverage for uninsured employers with respect to employees in the State.

Explanation of Provision

The provision 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,[65] 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 remedy 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 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, the assets of the organization must revert to the State upon dissolution. 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.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997. No inference is intended as to the status of such organizations under present law.

4. Treatment of certain publicly traded partnerships (sec. 954 of the bill and sec. 7704 of the Code)

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

[65] Related coverage that is incidental to workmen's compensation insurance includes liability under Federal workmen's compensation laws, for example.

(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.[66] 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 31, 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 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).

[66] Omnibus Budget Reconciliation Act of 1987 (P.L. 100–203), sec. 10211(c).

Reasons for Change

The Committee believes 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 existing publicly traded partnership that elects under the provision 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 existing publicly traded partnership is any publicly traded partnership that is not treated as a corporation, so long as such treatment is not determined under the passive-type income exception of Code section 7704(c)(1). 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 15 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.

Effective Date

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

5. Exclusion from UBIT for certain corporate sponsorship payments (sec. 955 of the bill and sec. 513 of the Code)

Present 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.[67] If a tax-exempt organization receives sponsorship payments in connection with an event or other

[67] See *United States* v. *American College of Physicians,* 475 U.S. 834 (1986) (holding that activity of selling advertising in 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).

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.[68]

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 Committee believes 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 bill, 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.[69] Such a use or acknowledgment does not include 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).

The bill specifically provides that a 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 pay-

[68] 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 to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

[69] 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.

ment 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 the sale of advertising or acknowledgments in tax-exempt organization periodicals. 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 specific event conducted by the payee organization. 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.

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.

6. Timeshare associations (sec. 956 of the bill and sec. 528 of the Code)

Present 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 taxable 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 a tax-exempt social welfare organization under section 501(c)(4) or as a regular C corporation. 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 present 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 Committee understands that the IRS recently has 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 Committee believes that the activities of timeshare associations are sufficiently similar to those of homeowners associations that they should be similarly taxed. Accordingly, the Committee bill would extend 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

The bill amends section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations would 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). Thus, 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 the timeshare association. In addition, at least 90 percent of the expenditures of the timeshare association must be for activities provided by the association to, or on behalf of, members of the timeshare association. 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, in order to qualify, the timeshare association must elect to be taxed under section 528. 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.

Effective Date

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

7. Modification of advance refunding rules for certain tax-exempt bonds issued by the Virgin Islands (sec. 957 of the bill and sec. 149 of the Code)

Present Law

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.

Virgin Island bonds

Under present law, the Virgin Islands is 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 proposed non-tax law change, the priority lien requirement would be repealed.

Reasons for Change

The Committee believes that an additional advance refunding is appropriate in light of changed circumstances with respect to these bonds.

Explanation of Provision

One additional advance refunding would be allowed for governmental bonds issued by the Virgin Islands that were advance refunded before June 9, 1997, if the Virgin Islands debt provisions are changed to repeal the current priority first lien requirement.

Effective Date

The provision is effective on the date of enactment.

8. Deferral of gain on certain sales of farm product refiners and processors (sec. 958 of the bill and sec. 1042 of the Code)

Present 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 a eligible worker-owed 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 Committee believes it appropriate to facilitate the transfer of refiners and processors to farmers' cooperatives.

Explanation of Provision

The bill extends the deferral provided under section 1042 to the sale of stock of a qualified refiner or processor to an eligible farmer's 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 such products to be refined or processed from farmers who make up the cooperative which is purchasing the stock or the cooperative. 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 bill applies to gain on the sale of stock by a C corporation.

Effective Date

The provision applies to sales after December 31, 1997.

9. Information returns on real estate transactions (sec. 959 of the bill and sec. 6045(e) of the Code)

Present Law

Persons who close real estate transactions are required to file informational returns with the IRS. There returns, filed on Form 1099S, are required to show the name and address of the buyer and seller of the real estate, details with regard to the gross proceeds of the sale, the portion of any real property tax which is treated as a tax imposed on the purchaser, and whether or not any financing of the seller was federally-subsidized indebtedness.

Reasons for Change

The Committee believes that informational returns should not generally be required on sales of personal residences where the sales price does not exceed the amount eligible to be excluded from income.

Explanation of Provision

The bill excludes 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. In order to be eligible for this exclusion, the person who would otherwise be required to file the informational 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) and that no financing of the seller was federally-subsidized indebtedness.

Effective Date

The provision is effective for informational returns otherwise required to be filed with regard to real estate sales occurring after the date of enactment.

10. Increased deduction for business meals while operating under Department of Transportation hours of service limitations (sec. 960 of the bill and sec. 274(n) of the Code)

Present 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 Committee believes that it is appropriate to allow a higher percentage of the cost of food and beverages consumed while away from home by these individuals to be deducted than is allowed under the general rule.

Explanation of Provision

The bill increases 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.

The increase in the deductible percentage is phased in according to the following schedule:

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.

11. Treatment of construction allowances provided to lessees (sec. 961 of the bill and new sec. 110 of the Code)

Present 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)).[70] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[71] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168 (b)(3), (c)(1), (d)(2), and (I)(6)). 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"). Incentive payments have been includible in income as accessions to

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

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

wealth.[72] However, a coordinated issue paper issued by the Internal Revenue Service on October 8, 1996, provides 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 and 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 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 Committee understands that it is common practice for a lessor to custom improve retail space for the use by a lessee pursuant to a lease. Such leasehold improvements generally may be provided by the lessor 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 to build or improve the property. The Committee believes that the tax treatment of either case should be the same. The Committee understands that the IRS paper on this issue reaches a similar conclusion in cases where the lessor is treated as the tax owner of the constructed or improved property. However, the Committee is 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 bill 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 and used pursuant to a short-term lease. In addition, the bill provides safeguards to ensure that lessors and lessees consistently treat the property subject to the construction allowance as nonresidential real property.

Explanation of Provision

The bill 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 nonresiden-

[72] *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).

tial 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 bill provides that lessor will treat the amounts expended on the construction allowance as nonresidential real property. However, the lessee's exclusion is not dependent upon the lessor's treatment of the property as nonresidential real property.

The bill contains reporting requirements to ensure that both the lessor and lessee treat such amounts as nonresidential real property. 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 bill. It is expected that the Secretary, in promulgating such regulations, will attempt to minimize the administrative burdens of taxpayers while ensuring compliance with the bill.

Effective Date

The provision applies to leases entered into after the date of enactment. No inference is intended as to the treatment of amounts that are not subject to the provision.

12. Treatment of consolidation of certain mutual savings bank life insurance departments (sec. 962 of the bill and sec. 594 of the Code)

Present Law

Special rules for mutual savings banks with life insurance business

Present law provides for special treatment of a mutual savings bank conducting a life insurance business in a separate life insurance department (Code sec. 594). Under the special rule, the insurance and noninsurance businesses of such banks are bifurcated, and the tax imposed is the sum of the partial taxes computed on (a) the taxable income of the mutual savings bank determined without regard to items properly allocable to the life insurance business, and (b) the income of the life insurance department, calculated in accordance with the rules applicable to life insurance companies (subchapter L of the Code). This special treatment applies so long as the mutual savings bank is authorized under State law to engage in the business of issuing life insurance contracts, the life insurance business is conducted in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, and the life insurance department would qualify as a life insurance company under Code section 816 if it were treated as a separate corporation.

Rules for corporate reorganizations

Present law provides that certain corporate reorganization transactions, including recapitalizations, generally are treated as tax-free transactions (sec. 368(a)(1)(E)). No gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are (in pursuance of the plan of reorganization) exchanged solely for stock or securities in that corporation or in another corporation that is a party to the reorganization, except that gain (if any) to the recipient is recognized to the extent the principal amount of securities received exceeds the principal amount of the securities surrendered (secs. 354, 356(a)(1)). If such an exchange has the effect of distribution of a dividend, then the portion of the distributee's gain that does not exceed his ratable share of the corporation's earnings and profits is treated as a dividend (sec. 356(a)(2)).

Rules for life insurance companies

A life insurance company generally is permitted to deduct the amount of policyholder dividends paid or accrued during the taxable year (sec. 808). In the case of a mutual life insurance company, the amount of the deduction for policyholder dividends is reduced (but not below zero) by the differential earnings amount (sec. 809). The term policyholder dividend includes (1) any amount paid or credited (including as an increase in benefits) if the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management; (2) excess interest; (3) premium adjustments; and (4) experience-rated refunds.

Reasons for Change

The Committee believes that the consolidation of life insurance departments of mutual savings banks should not fail to be treated as a tax-free consolidation transaction because it meets the requirements of State law governing the consolidation transaction. Similarly, where the related distribution to of cash to policyholders whose policies have not lapsed occurs as a requirement of State law, and the policyholders have no divisible right to surplus, no right to vote or to approve the consolidation transaction, the distribution to participating policyholders whose policies were in effect immediately before the consolidation should not fail to be treated as a policyholder dividend.

Explanation of Provision

The provision provides that the consolidation of two or more life insurance departments of mutual savings banks into a single life insurance company by requirement of State law is treated as a tax-free reorganization described in section 368(a)(1)(E) (i.e., a recapitalization). Any payments required to be made to policyholders in connection with the consolidation are treated as policyholder dividends deductible by the company under section 808, provided that certain requirements are met. The requirements are: (a) the payments are only with respect to policies in effect immediately before the consolidation; (b) the payments are only with respect to policies that are participating (i.e., on which policyholder dividends are paid) before and after the consolidation; (c) the payments cease with respect to any policy if the policy lapses after the consolidation; (d) the policyholders before the consolidation had no divisible right to the surplus of any life insurance department and had no right to vote; and (e) the approval of the policyholders was not required for the consolidation. No inference is intended as to the tax treatment of (1) consolidation, demutualization or other transactions involving, or (2) payments to policyholders of, any insurer or financial institution other than the life insurance departments of mutual savings banks.

Effective Date

The provision takes effect on December 31, 1991.

13. Offset of past-due, legally enforceable State tax obligations against Federal overpayments (sec. 963 of the bill and sec. 6402 of the Code)

Present Law

Overpayments of Federal tax may be credited against any liability in respect of an internal revenue tax on the part of the person who made the overpayment. Any overpayment not so credited may be offset against any past-due support payments and past-due legally enforceable debts owed to Federal agencies of the person making the overpayment. Any remaining overpayment is required to be refunded.

Reasons for Change

The Committee believes that the collection of legally enforceable state tax obligations, owed to a State by its residents, should be facilitated. However, the Committee also believes that the Federal government should not be made a party to disputes between a State and residents of another State. Consequently, Federal tax overpayments may be offset for this purpose only if the return establishing the overpayment shows an address within the State seeking the offset.

Explanation of Provision

An overpayment of Federal tax could be offset by the amount of any past-due, legally enforceable State tax obligation, provided the person making the overpayment has shown on the return establishing the overpayment an address that is within the State seeking the offset. For this purpose, a past-due, legally enforceable State tax obligation is a debt which resulted from a judgement rendered by a court of competent jurisdiction, or a determination after an administrative hearing, which determined an amount of State tax to be due and which is no longer subject to judicial review, as well as from an assessment the time for which redetermination has expired that has not been delinquent for more than 10 years. A State tax obligation includes any local tax administered by the chief tax administration agency of the State.

The Secretary of the Treasury will establish regulations prescribing the time and manner in which States may submit notices of past-due, legally enforceable State tax obligations and may require States to pay a fee to reimburse the Secretary for the cost of applying the offset procedure.

The offset for a past-due, legally enforceable state tax obligation of a state resident will apply after the offsets provided in present law for internal revenue tax liabilities, past-due support, and past-due, legally enforceable obligations owed a Federal agency. The Secretary of the Treasury is authorized to issue regulations establishing procedures for the implementation of this proposal.

Effective Date

The provision is effective for refunds payable after December 31, 1998.

14. Exemption of the incremental cost of a clean fuel vehicle from the limits on depreciation for vehicles (sec. 964 of the bill and sec. 280F of the Code)

Present 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 automobile component of the Consumer Price Index. Consequently, the limitations applicable for 1997 are $3,160, $5,000, $3,050, and $1,775.

Reasons for Change

The Committee believes that the price of a clean-burning fuel vehicle or an electric vehicle does not necessarily represent the consumer's purchase of a luxury. 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 Committee believes 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 Committee believes 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 bill modifies the section 280F 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 vehicle to be propelled by a clean burning fuel, the bill generally modifies present-law by applying the current 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 allowable as a depreciation deduction on the installed qualified clean- burning fuel, without regard to the 280F limitation. Generally, this has the same effect as only subjecting the cost of the vehicle before modification to the sec. 280F limitations.

For example, assume that in 1997, after the date of enactment, a taxpayer purchases a clean-burning fuel vehicle for $43,000. Further assume that had the taxpayer purchased the identical vehicle, without having had certain components replaced to qualify it as clean burning, the price paid would have been $39,000. The cost of the qualified retrofit parts and components is $4,000. The depreciation that the taxpayer may claim for this vehicle in any year is the depreciation that could be claimed under present law section 280F for that portion of the vehicle worth $39,000, plus the depreciation that can be claimed under section 168 for the $4,000 worth of qualified retrofit parts and components.

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 on or after the date of enactment and before January 1, 2005.

15. Exemption from tax upon death of a policy officer in the line of duty (sec. 965 of the bill and new sec. 138 of the Code)

Present 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.

Survivor annuity benefits paid under a governmental retirement plan to a survivor of a law enforcement officer killed in the line of duty are generally includible in income. Amounts contributed to the plan by the officer and previously included in the officer's income would not be includible in the survivor's income.

Reasons for Change

The Committee believes that it is appropriate to apply to the survivors of law enforcement 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 bill generally provides that an amount paid as a survivor annuity on account of the death of a law enforcement officer who is killed in the line of duty will be 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 law enforcement officer or to a child 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.

16. Temporary suspension of taxable income limit on percentage depletion for marginal production (sec. 966 of the bill and sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions (sec. 613A). 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 these deductions may not exceed 65 percent of the taxpayer's taxable income (excluding, for this purpose, percentage depletion net operating loss carrybacks, and capital loss carrybacks). If a portion of percentage depletion deductions are disallowed by this limitation, the disallowed amount may be deducted in the following year.

Specific percentage depletion rules apply to oil and gas production from "marginal" properties. 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.

Reasons for Change

The Committee determined that a limited modification of the net income limit for marginal oil and gas production is an appropriate part of overall national energy security policy.

Explanation of Provision

The 65-percent-of-net-income 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 is effective on the date of enactment.

G. EXTENSION OF DUTY-FREE TREATMENT UNDER GENERALIZED SYSTEM OF PREFERENCES; TARIFF TREATMENT OF CERTAIN EQUIPMENT AND REPAIR OF VEHICLES

1. Generalized System of Preferences (sec. 971 of the bill)

Section 971 of the bill reauthorizes Title V of the Trade Act of 1974, as amended (Generalized System of Preferences, "GSP") for two years to expire on May 31, 1999.

Prior Law

Title V of the Trade Act of 1974, as amended, (Generalized System of Preferences), 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 on May 31, 1997.

Explanation of Provision

The bill reauthorizes the GSP program for two years, to expire on May 31, 1999. The bill provides for refunds, upon request of the importer, of any duty paid between May 31, 1997, and the date of enactment.

Effective Date

The provision is effective upon date of enactment.

2. Temporary suspension of vessel repair duty (shipbuilding) (sec. 972 of the bill and sec. 466 of the Tariff Act of 1930)

Present Law

Section 466 of the Tariff Act of 1930 establishes a 50-percent duty of repairs made outside the United States to U.S. flag vessels.

Reasons for Change

A permanent repeal of the vessel repair statute was included in H.R. 2754 during the 104th Congress, the bill to implement the Shipbuilding Agreement negotiated under the auspices of the Organization for Economic Cooperation and Development ("OECD"), in order to meet U.S. obligations under that Agreement. H.R. 2754 was never enacted into law.

The Committee intends that this provision be considered a temporary, one-time measure to aid ship operators while the Congress continues to try to implement the Shipbuilding Agreement. The Committee strongly supports the Shipbuilding Agreement and hopes that it can be implemented so that it may take effect as soon as possible, with the inclusion at that time of a permanent repeal of the vessel repair duty.

Explanation of Provision

The bill suspends for a one-year period beginning on date of enactment the current 50-percent duty on repairs to U.S. flag vessels made in countries that are signatories to the OECD Shipbuilding Agreement.

Effective Date

The provision is effective for repair activities occurring for a one-year period beginning on the date of enactment.

H. UNITED STATES-CARIBBEAN BASIN TRADE PARTNERSHIP ACT (SECS. 981–988 OF THE BILL)

Subtitle H of Title IX provides additional trade benefits to Caribbean Basin Initiative (CBI) countries comparable to tariff and quota treatment under the North American Free Trade Agreement (NAFTA) on products not already eligible for CBI treatment subject to certain conditions and limitations.

1. Findings and Policy (sec. 982 of the bill)

Present Law

The CBI program was established by the Caribbean Basin Economic Recovery Act (CBERA), which was enacted on August 5, 1983. This legislation authorized the President to grant duty-free treatment to the imports of eligible articles from designated Caribbean countries. The basic purpose of the CBI program, as originally proposed by President Ronald Reagan, was to respond to an economic crisis in the Caribbean by encouraging industrial development primarily through preferential access to the U.S. market. The goal was to promote political and social stability in the strategically important region. CBI trade benefits were made permanent in 1990.

Explanation of Provision

Section 982 contains findings of the Congress that:

(1) The United States apparel industry is a major component of the United States manufacturing sector of the United States, employing more than 650,000 people.

(2) In 1973 the United States apparel industry supplied 88 percent of the garments consumed by Americans, and in 1995 that share fell to less than 50 percent.

(3) Countries in the Western Hemisphere offer the greatest opportunities for increased exports of United States textile and apparel industry.

(4) Given the greater propensity of countries located in the Western Hemisphere to use United States components and to purchase United States products compared to other countries, increased trade and economic activity between the United States and countries in the Western Hemisphere will create new jobs in the United States as a result of expanding opportunities.

(5) The Caribbean Basin Initiative represents a permanent commitment by the United States to encourage the development of strong democratic governments and revitalized economies in neighboring countries in the Caribbean Basin region.

(6) The economic security of the countries in the Caribbean Basin is potentially threatened by the diversion of investment to Mexico as a result of the North America Free Trade Agreement (NAFTA).

(7) To preserve the U.S. commitment to Caribbean Basin beneficiary countries, and to help further their economic development, it is necessary to offer temporary benefits equivalent to the trade treatment accorded to products of NAFTA members.

(8) Offering NAFTA equivalent benefits to Caribbean Basin Initiative countries, pending their eventual accession to the NAFTA, will promote the growth of free enterprise and economic opportunity in the region and thereby enhance the national security interests of the United States.

Section 982 states that it is, therefore, the policy of the United States to: (1) assure that the domestic textile and apparel industry remains competitive in the global marketplace by encouraging the formation and expansion of "partnerships" between the textile and apparel industry of the United States and the textile and apparel industry of various countries located in the Western Hemisphere; and, (2) offer Caribbean Basin partnership countries tariff and quota treatment equivalent to that accorded to products of NAFTA countries, and to seek the accession of these partnership countries to the NAFTA or a free trade agreement comparable to the NAFTA at the earliest possible date, with the goal of achieving full NAFTA participation by all Caribbean countries by January 1, 2005. This date is consistent with the goals of completing negotiations of the "Free Trade Area of the Americas" which was announced by the hemisphere's leaders at the Summit of the Americas in December 1994.

2. Temporary duty and quota treatment provided to partnership countries (sec. 984 of the bill)

Present Law

Under the CBERA, imports from CBI, except for certain products that are statutorily excluded, are granted duty-free treatment, subject to specific eligibility requirements. Statutorily excluded articles are ineligible for duty-free treatment under the CBI. These excluded products are: textile and apparel articles that are subject to textile agreements, canned tuna, petroleum and petroleum products, footwear, handbags, luggage, flat goods, work gloves, and leather-wearing apparel. Also excluded are certain watches and watch products.

Under NAFTA, imports of these products from Mexico (excluded from CBI and listed above) receive either declining tariff or duty-free and quota-free treatment.

Explanation of Provision

Section 984 of the bill amends section 213(b) of the CBERA to provide tariff and quota treatment on imports from CBI beneficiary countries of excluded articles that is identical to tariff and quota treatment accorded like articles imported from Mexico under the NAFTA during a temporary period of up to one year.

a. Rules of origin

Present Law

Chapter Four of the NAFTA establishes rules of origin for identifying goods that are to be treated as "originating in the territories of the NAFTA parties" and are therefore eligible for preferential treatment accorded to originating goods under the NAFTA, including reduced duties and duty-free and quota-free treatment.

Explanation of Provision

The bill provides that NAFTA tariff and quota treatment would apply to CBI articles which meet NAFTA rules of origin (treating the United States and CBI beneficiary countries as "parties" under the agreement for this purpose). Customs procedures applicable to exporters under the NAFTA also must be met for partnership countries to qualify for parity treatment. Imports of articles currently excluded under CBI, which do not meet the conditions of NAFTA parity, would continue to be excluded from the CBI program.

b. Effective date and termination of temporary treatment

Present Law

CBI trade benefits were made permanent in 1990.

Explanation of Provision

Under section 984 a temporary transitional period would begin January 1, 1998, and end on the date that either NAFTA accession or a reciprocal free trade agreement enters into force with the beneficiary country, or on December 31, 1998, whichever is earlier.

c. General review of beneficiary countries

Present Law

Section 212(f) of the CBERA requires the President, every three years, to submit to the Congress a complete report regarding the operation of the CBI program, including the results of a general review of beneficiary countries.

Explanation of Provision

Section 984 of the bill amends section 212(f) of the CBERA to provide that the next review takes place one year after the effective date of the bill and subsequent reviews occur at three year intervals thereafter. The bill requires the President to conduct and report to Congress on triennial reviews of the benefits accorded under the bill. The review will be based on the 17 eligibility criteria listed in section 212 of the CBERA, as further interpreted by the bill. These criteria include intellectual property protection, investment protection, market access, worker rights, cooperation in administering the program, and the degree to which the country follows accepted rules of international trade provided for under the World Trade Organization. The President may determine, based on the review, whether to withdraw, suspend, or limit new parity benefits. Existing authority in the CBERA would continue to withdraw, suspend, or limit current benefits at any time based on present criteria.

The Subcommittee is aware that questions periodically arise regarding beneficiary countries' adherence to the eligibility criteria under section 212 of the CBERA, as amended. As part of the implementation of this legislation, the Subcommittee expects the President to offer adequate opportunities for interested parties to present information concerning CBERA beneficiaries' adherence to the eligibility criteria.

d. Safeguards

Present Law

The import relief procedures and authorities under section 201–204 of the Trade Act of 1974 apply to imports from CBI partnership countries, as they do to imports from other countries. If CBI imports cause or threaten to cause serious injury to the domestic industry producing a like or directly competitive article, section 213(e) of the CBERA authorizes the President to suspend CBI duty-free treatment and proclaim a rate of duty or other relief measures.

Under NAFTA, the U.S. may invoke a special safeguard provision at any time during the tariff phase-out period if a NAFTA-origin textile or apparel good is being imported in such increased quantities and under such conditions as to cause "serious damage, or actual threat thereof," to a domestic industry producing a like or directly competitive good. The President is authorized to either suspend further duty reductions or increase the rate of duty to the most-favored-nation rate for up to three years. The NAFTA also provides for a "quantitative restriction" safeguard, which the United States or Mexico may invoke against "non-originating" textile or apparel goods, using the standard of "serious damage, or actual threat thereof."

Explanation of Provision

Normal safeguard authorities under CBERA would apply to imports of all products except textiles and apparel. NAFTA equivalent safeguard authorities would apply to imports of textile and apparel products from CBI countries, except that, under the bill, the President would not be obligated to provide equivalent trade liberalizing compensation to the exporting country. Nothing in this provision is intended to limit the rights of the United States or of the Caribbean nations under the Uruguay Round Agreement on Textiles and Clothing, especially in light of the fact that the binational panel review system established under NAFTA does not apply to the Caribbean.

e. Treatment of textile and apparel imports from Caribbean countries and Mexico

1. GAL Program

Present Law

The "Special Access Program for Textiles," established by regulation in February 1986, provides flexible Guaranteed Access Levels (GALs) to the U.S. market for textile or apparel and "made up" textile product categories (not fabric, yarn, or other textile products) assembled in CBI countries from fabrics wholly formed and cut in the United States, under bilateral agreements negotiated at the request of each Caribbean government. GALs are separate limits from (and usually significantly higher than) standard quota levels, and are generally increased upon request of the exporting country.

Explanation of Provision

Section 984 eliminates import restraint and consultation levels and duties on textile and apparel articles originating in a partnership country. Under the bill, duty-free and quota free treatment applies to apparel that is: (1) subject to the "GAL" program, and which meets the NAFTA yarn-forward rule of origin; (2) cut and sewn in a partnership country from fabrics wholly formed in the United States, from yarns wholly formed in the United States; (3) is knit-to-shape from yarns wholly formed in the United States; and (4) is made from fabric knit in a partnership country from yarn wholly formed in the United States. Hand-made, hand-loomed and folklore articles of the region also qualify for duty-free and quota-free treatment.

2. Originating textile and apparel goods

Present Law

Certain textile and apparel articles from major supplying CBI countries are subject to import quotas under bilateral agreements negotiated on a product-category basis under authority of Section 204 of the Agricultural Act of 1956 and in accordance with the Uruguay Round Agreement on Textiles and Clothing. Articles under quota may be assembled from U.S. and/or foreign components.

Explanation of Provision

Under section 984, imports of textile and apparel products meeting NAFTA rules of origin would receive NAFTA equivalent tariff treatment and enter quota-free. There would be no change in the treatment of non-originating textile products currently subject to import quotas under bilateral and multilateral textile agreements.

3. Trade Preference Levels (TPLs)

Present Law

Appendix 6(B) of the NAFTA provides a limited exception to the NAFTA rules of origin for textile and apparel goods. The exception takes the form of Tariff Preference Levels (TPLs) under which specific quantities of goods from each NAFTA country that do not meet NAFTA "yarn-forward" rules of origin will nonetheless be accorded NAFTA preferential tariff rates. Imports of such goods that exceed these quantities will be subject to MFN duty rates. Under NAFTA, TPLs are available for three broad categories of products: (1) cotton or man-made apparel; (2) wool apparel; and (3) goods entered under subheading 9802.00.80 of the HTS.

Explanation of Provision

Section 984 authorizes the USTR to establish TPLs for Caribbean textile and apparel products which are similar to those established for Mexico in the NAFTA. After consulting with the domestic industry and other interested parties, USTR is authorized to establish TPLs in the following categories at specified levels: not more than 45,000,000 square meter equivalents of cotton or man-made fiber apparel; not more 1,500,000 square meter equivalents of wool apparel; and, not more than 25,000,000 square meter equivalents of goods entered under subheading 9802.00.80 of the HTS.

The bill requires that these amounts be allocated among the seven partnership countries which have the largest volume of textile and apparel exports to the United States, based on a pro rata share of the volume of their textile and apparel exports.

f. Customs procedures and penalties for transshipment

Present Law

Under NAFTA, Parties to the Agreement must observe Customs procedures and documentation requirements which are established in Chapter 5 of the NAFTA. Requirements regarding Certificates of Origin for imports receiving preferential tariffs are detailed in Article 502.1 of the NAFTA.

Explanation of Provision

The bill directs the Secretary of the Treasury to prescribe regulations that require, as a condition of entry, that any importer of record that claims preferential tariff treatment for textile and apparel products under the bill must comply with requirements similar in all material respects to the requirements regarding Certificates of Origin contained in 502.1 of the NAFTA, for a similar importation from Mexico. In addition, if an exporter is determined under the laws of the United States to have engaged in illegal transshipment of textile or apparel products from a partnership country, then the President shall deny all benefits under the bill to such exporter, and to any successors of such exporter, for a period of 2 years.

5. Treatment of sugar imports (sec. 985 of the bill)

Present Law

Under the tariff-rate quota system for sugar, which was proclaimed by the President on December 23, 1994, the Secretary of Agriculture establishes the quota quantity that can be entered at the lower tier import duty-rate. The USTR allocates quantities to CBI countries that receive duty-free treatment. Imports above the in-quota amount from CBI countries are tariffed at the higher over-quota rates.

The quantity of sugar which may be imported duty-free from Mexico is governed by Section A of Annex 703.2 of the NAFTA. Under NAFTA, access grows over time to unlimited duty-free access for exports of sugar from Mexico beginning in the year 2009.

Explanation of Provision

Section 985 responds to concerns raised by CBI beneficiary governments that additional access to the U.S. sugar market could potentially result in a decrease in access for exports of sugar from the Caribbean and thereby reduce employment in the region. Section 102 requires the President to monitor the effects, if any, of the NAFTA on access to the U.S. sugar market by CBI beneficiary countries. If the President considers that NAFTA implementation is affecting or likely will affect market access adversely, the President shall: (1) take action by Executive authority after consulting with interested parties and appropriate committees, or (2) propose legislation necessary or appropriate to ameliorate such effects.

6. Rum imports (sec. 986 of the bill)

Present Law

Rum and beverages made with rum are eligible for duty-free entry into the United States both under the CBI program and NAFTA, provided they meet the CBI or NAFTA rules of origin and other requirements. When Caribbean rum is processed in Canada into a rum beverage and the beverage is exported from Canada into the United States, it is not eligible for duty-free treatment under either the CBI or the NAFTA. The beverage is ineligible for duty-free treatment under CBI because it is not shipped directly from a beneficiary country to the United States as the CBI rules require. The beverage does not qualify for NAFTA duty-free treatment because the processing in Canada is not sufficient to qualify it as a NAFTA "originating good."

Explanation of Provision

To address this situation Section 986 amends the CBERA to accord duty-free treatment to certain beverages imported from Canada if: (1) the rum is the growth, product, or manufacture of a beneficiary country or the U.S. Virgin Islands; (2) the rum is imported directly into Canada, and the beverages made from it are imported directly from Canada into the United States; and, (3) the rum accounts for at least 90 percent by volume of the alcoholic content of the beverages.

7. Meeting of Caribbean Trade Ministers and USTR (sec. 987 of the bill)

Present Law

No provision.

Explanation of Provision

Section 987 directs the President to convene a meeting with the trade ministers of CBI beneficiary countries in order to establish a schedule of regular meetings, to commence as soon as practicable, of the trade ministers and the USTR. The purpose of the meetings shall be to further consultations between the U.S. and partnership countries concerning the likely timing and procedures for initiating negotiations for partnership countries to: (1) accede to NAFTA; or (2) enter into comprehensive, mutually advantageous trade agreements with the United States that contain comparable provisions to the NAFTA, and would make substantial progress in achieving the negotiation objectives listed in Section 108(b)(5) of Public Law 103–182. (These are general trade negotiating objectives for future free trade agreements which were included in the NAFTA implementing bill.)

TITLE X. REVENUE-INCREASE PROVISIONS

A. FINANCIAL PRODUCTS

1. Require recognition of gain on certain appreciated positions in personal property (sec. 1001(a) of the bill and new sec. 1259 of the Code)

Present 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.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly-purchased securities. The Code provides 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"). These arrangements do 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) without a taxable disposition. 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 long stock so that, economically, the transaction strongly resembles a sale of the stock held.

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 rule

The bill 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 would recognize 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 constructive sale would generally not be treated as a sale for other Code purposes. An appropriate adjustment in the basis of the appreciated financial position would be made in the amount of any gain realized on a constructive sale, and a new holding period of such position would begin 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 contact 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, for a taxpayer that has entered into a short sale, a notional principal contract or a futures or forward contract, the taxpayer 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.

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.

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. 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 would 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 would be determined under the rules governing actual sales, after adjusting for previous constructive sales under the bill. Under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or its offsetting transaction might in some circumstances be disaggregated on a non-pro rata basis for purposes of the constructive sale determination.

The bill 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. This exception does not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter unless (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.

A transaction that has resulted in a constructive sale of an appreciated financial position (e.g., a short sale) is not to be 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 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. An exception is provided for debt instruments the interest on which is not contingent on profits, the borrower's discretion, or similar factors and which are not convertible, directly or indirectly, into stock. Other debt instruments, including those identified as part of a hedging or straddle transaction, are appreciated financial positions.

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.

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery of a substantially fixed amount of property and a substantially fixed price. Thus, a forward contract providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale.

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 dealers) 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.

Treasury guidance

The provision 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). Under section 7805(b)(2), the Treasury generally is prohibited from issuing regulations that are retroactive, unless such regulations are issued within 18 months of the date of enactment of the provision.

It is anticipated that the Treasury will use the provision's authority to 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 or gain with respect to the appreciated financial position. Because this standard requires reduction of both risk of loss and opportunity for gain, it is intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered. Thus, for example, it is not intended 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.

For purposes of the provision, it is not intended that risk of loss and opportunity for gain be considered separately. 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, it is intended that Treasury regulations will treat this transaction as a constructive sale of the position.

It is 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 range price 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, it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. Similarly, 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).

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 exercisable at a future date (a so-called "European" 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 and assured himself of all yield and gain on the stock for any appreciation up to $120. In determining whether such a transaction will be treated as a constructive sale, it is 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 identifies the offsetting positions of the earlier transaction within 30 days after the date of enactment. The special rule will cease to apply to on the date the taxpayer ceases to hold any of the 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 proposal) occurred before such date, (2) the transaction remains open for not less than two years, and (3) the transaction is not closed in a taxable transaction within 30 days after the date of enactment, such position (and any property related to it, under principles of the provision) will be treated as property constituting rights to receive income in respect of a decedent under section 691.

2. Election of mark to market for securities traders and for traders and dealers in commodities (sec. 1001(b) of the bill and new sec. 475(d) of the Code)

Present 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. The mark-to-market treatment applicable to securities dealers does 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 inventory using the lower-of-cost-or-market method for Federal income tax purposes.

Explanation of Provision

The bill allows securities traders and commodities traders and dealers to elect application of the mark-to-market accounting rules, which apply only to securities dealers under present 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 dealer or 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. As for securities dealers under present law, gain or loss recognized by an electing taxpayer under the provision is ordinary gain or loss.

With respect to a commodities dealer, all of the provisions of present law section 475 apply as if commodities were securities. Commodities for purposes of the provision would include only commodities of a kind customarily dealt in on an organized commodities exchange. It is anticipated that Treasury regulations will provide that section 475(c)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment, will apply only to contacts and instruments referenced to commodities in the case of a commodities dealer.

For securities traders, some of the provisions of present law section 475 apply, but others that are specific to dealers do not. For example, because a securities trader does not hold inventory, the mark-to-market rules for inventory are not applicable to traders. In addition, securities that are not held in connection with the trade or business of a securities trader are excluded from mark-to-market treatment if the trader identifies the securities in the trader's records before the close of the day on which they are acquired under rules similar to those of section 475(b)(2) for dealers. The provisions applicable to securities traders apply to commodities traders as if commodities were securities.

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 would apply to taxable years of securities traders ending after the date of enactment. For a taxpayer making the election, the adjustments required under section 481 as a result of the change in accounting method are required to be taken into account ratably over a four-year period.

For elections made for the first taxable year ending after the date of enactment, the taxpayer must identify the securities or commodities to which the election will apply within 30 days of the date of enactment.

3. Limitation on exception for investment companies under section 351 (sec. 1002 of the bill and sec. 351(e) of the Code)

Present 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 own 80 percent of the voting stock of each class of stock entitled to vote. 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 present law and regulations, a partnership or a corporation is not treated as an investment company even though more than 80 percent of its assets are a combination of readily marketable 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 present law, a partner may contribute stock, securities or other assets to an investment partnership, and a shareholder may contribute such assets to a corporation (e.g., a RIC) and, without current taxation, receive an interest in an entity that is essentially a pool of high-quality investment assets. Where, as a result of such a transaction, the partner or shareholder has diversified or otherwise changed the nature of the financial assets in which it has an interest, the transaction has the effect of a taxable exchange. Of particular concern to the Committee is 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 bill modifies 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 marketable stock and securities as under present law.

Under the bill, an investment company includes a RIC or REIT as under present law. In addition, under the bill, an investment company includes any corporation or partnership if more than 80 percent of its assets by value consist of money, financial instruments, foreign currency, interests in REITs, RICs, common trust funds and publicly-traded partnerships, and certain interests in precious metals and entities that hold the above-listed items.[1] In addition, the bill grants regulatory authority to the Treasury to add other assets to the list set out in the provision.

The bill is intended to 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 bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351–1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionally by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351–1(c)(4)), (3) 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)), and (4) 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 binding written contract in effect on June 8, 1997, and at all times thereafter until the transfer.

[1] Where assets are defined by reference to provisions of section 731(c)(2), it is intended that the Treasury regulations promulgated under those provisions will also be applicable.

4. Disallowance of interest on indebtedness allocable to tax-exempt obligations (sec. 1003 of the bill and sec. 265 of the Code)

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (sec. 265). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.[2]

Application to non-financial corporations

General guidelines.—In Rev. Proc. 72–18, 1972–1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. Under Rev. Proc. 72–18, a deduction is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations.

This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception.—In the case of an individual, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.—If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of busi-

[2] Code section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of P.L. 98–369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

ness in payment for services performed for, or goods supplied to, State or local governments.[3]

Application to financial corporations and dealers in tax-exempt obligations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which is not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer (sec. 265). In the case of an obligation of an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than certain private activity bonds) within a calendar year (the "small issuer exception"), only 20 percent of the interest allocable to such tax-exempt obligations is disallowed (sec. 291(a)(3)). A similar pro rata rule applies to dealers in tax-exempt obligations, but there is no small issuer exception, and the 20-percent disallowance rule does not apply (Rev. Proc. 72–18).

Treatment of insurance companies

Present law provides that a life insurance company's deduction for additions to reserves is reduced by a portion of the company's income that is not subject to tax (generally, tax-exempt interest and deductible intercorporate dividends) (secs. 807 and 812). The portion by which the life insurance company's reserve deduction is reduced is related to its earnings rate. Similarly, in the case of property and casualty insurance companies, the deduction for losses incurred is reduced by a percentage (15 percent) of (1) the insurer's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates) (sec. 832(b)(5)(B)). If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in the property and casualty insurer's income.

Reasons for Change

The Committee believes that the rules adopted by the Internal Revenue Service to administer the interest disallowance rule as they apply to corporations needs modifications. The Committee believes that the Internal Revenue Service is correct that the interest disallowance rule should not apply to tax-exempt holdings by corporations that acquired those tax-exempt obligations in the ordinary course of business as payment for goods and services provided to State and local governments. On the other hand, the Committee believes that the present law 2 percent safe harbor is inappropriately large to be considered as de minimis in the case of large corporations. Instead, the Committee believes that more appropriate de minimis exception is where holdings of tax-exempt obligations are less than $1 million (or 2 percent of the corporation's assets, if less). The Committee believes that more objective rules need to be adopted to enforce the interest disallowance rule. Specifically, the Committee believes that a pro rata allocation of debt to tax-ex-

[3] *R.B. George Machinery Co.,* 26 B.T.A. 594 (1932) acq. C.B.XI–2, 4; Rev. Proc. 72–18, as modified by Rev. Proc. 87–53, 1987–2 C.B. 669.

empt obligations assets is appropriate in determining the amount of interest to be disallowed because a pro rata rule (1) is consistent with its view that money generally is fungible and, consequently, that all borrowings of a corporation finance (or carry) all of the corporation's assets, including tax-exempt obligations, and (2) avoids the difficult and often subjective inquiry relating to when indebtedness is incurred or continued to purchase or carry tax-exempt obligations. In addition, the Committee believes that rules need to be adopted to enforce the interest disallowance rule in the case of consolidated and affiliated groups of corporations and partnerships with corporate partners. The Committee believes that the pro rata disallowance rule should not apply to insurance companies since present law contains rules that address holdings of tax-exempt obligations by insurance companies.

Explanation of Provision

General rule

The bill extends to all corporations (other than insurance companies) the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets. However, the bill does not extend the small-issuer exception to taxpayers which are not financial institutions.

Exceptions

The provision does not apply to nonsalable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. In addition, the bill provides a de minimis exception under which the disallowance rule does not apply to corporations, other than financial institutions and dealers in tax-exempt obligations, if the average adjusted basis of tax exempt obligations acquired after August 7, 1986, is less than the lesser of $1 million or 2 percent of the basis of all of the corporation's assets. Under the bill, insurance companies are not subject to the pro rata rule but would continue to be subject to present law.

Holdings by related persons

The provision applies the interest disallowance provision to all related persons that are members of the same consolidated group as if all the members of the group were a single taxpayer. The consolidated group rule is to be applied without regard to any member that is an insurance company. In the case of affiliated corporations that are not members of the same consolidated group, tracing rules apply as if all of the related persons are a single entity.

In the case of a corporation (other than a financial institution) that is a partner in a partnership, the corporate partners are treated as holding their allocable shares of all of the assets of the partnership.

The provision is not intended to affect the application of section 265 to related parties under current law.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment with respect to obligations acquired after June 8, 1997.

5. Gains and losses from certain terminations with respect to property (sec. 1004 of the bill and sec. 1234A of the Code)

Present Law

Treatment of gains and losses.—Gain from the "sale or other disposition" is the excess of the amount realized therefrom over its adjusted basis; loss is the excess of adjusted basis over the amount realized. The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset.[4] The U.S. Supreme Court has held that the term "sale or exchange" is a narrower term than "sale or other disposition."[5] Thus, it is possible from there to be a taxable income from the sale or other disposition of an asset without that gain being treated as a capital gain.

Treatment of capital gains and losses.—Long-term capital gains of individuals are subject to a maximum rate of tax of 28 percent.[6] 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.[7] 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 the 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).

Court decisions interpreting the "sale or exchange" requirement.—There has been a considerable amount of litigation dealing with whether modifications of legal relationships between taxpayers is be 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".[8] Several court decisions interpreted the "sale or exchange" requirement to mean that a disposition, that

[4] 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, 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.

[5] *Helvering* v. *William Flaccus Oak Leather Co.,* 313 U.S. 247 (1941).

[6] See bill section 311, which provides an alternative tax rates on long-term capital gains of 10 percent or 20 percent for taxpayers otherwise marginal bracket is 15 percent or greater than 15 percent, respectively.

[7] See bill section 321, which provides an alternative tax rate of 30 percent on corporate capital gains on assets held lower than 5 years.

[8] (The result in this case was overturned by enactment in 1934 of the predecessor of present law sec. 1271(a), see below). See section 117 of the Revenue Act of 1934, 28 Stat. 680, 714–715.

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), the taxpayer was treated as receiving ordinary income from amounts received for acquisition from the mine owner of a contract that the taxpayer had made with mine owner to buy all of the coal mined at a particular mine for a period of 10 years on the grounds that the payments were in lieu of subsequent profits that would have been taxed as ordinary income. Similarly, *Commissioner* v. *Starr Brothers,* 205 F. 2d 673 (1953), the Second Circuit held that a payment that a retail distributor received 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 was not a sale or exchange. In *National-Standard Company* v. *Commissioner,* 749 F. 2d 369, the Sixth Circuit held that a loss incurred the transfer of foreign currency to discharge the taxpayer's liability was an ordinary loss, since transfer was not a "sale or exchange" of that currency. More recently, in *Stoller* v. *Commissioner,* 994 F. 2d 855, 93-1 U.S.T.C. par. 50349 (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."

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 of 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[9] 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"[10] which is capital asset in the hands

[9] Treasury Regulations generally define "actively traded" as any personal property for which there are an established financial market. In addition, those regulations provided that "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 is personal property." Treas. Reg. sec. 1.092(c)–1(c).

[10] A "section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

of the taxpayer.[11] Section 1234A does not apply to the retirement of a debt instrument.

Retirement of debt obligations treated as sale or exchange.—Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefore (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID[12] 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 present law is governed by case law.

Reasons for Change

Extinguishment treated as sale or exchange.—In general, the Committee believes that present law is deficient since it (1) taxes similar economic transactions differently, (2) effectively provides some, but not all, taxpayers with an election, and (3) its lack of certainty makes the tax laws unnecessarily difficult to administer.

The Committee believes 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 present law treats modifications of property rights as not being a sale or exchange, present law effectively provides, in many cases, taxpayers with an election to treat the transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that can offset higher-taxed ordinary income and not be subject to limitations on use of capital losses. The effect of an election can be achieved by selling the property right if the resulting transaction results in a gain or providing for the extinguishment of the property right if the resulting transaction results 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 has caused uncertainty to both

[11] 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. There 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 the creation of an ordinary loss. In 1981, Congress believed that the effective ability of taxpayer to elect the character of a gain or loss leg of a straddle was unwarranted and provided the present law rule that a cancellation, lapse, expiration or other termination of a right is a sale or exchange. 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.

[12] The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation 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 on an accrual basis. The mandatory inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons 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)).

taxpayers and the Internal Revenue Service in the administration of the tax laws.

Accordingly, the Committee bill treats the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property as a "sale or exchange." A major effect of the Committee bill 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 Committee bill would be to reduce the uncertainty concerning the tax treatment of modifications of property rights.

Character of gain on retirement of debt obligations issued by natural persons.—Similar objections can be raised about the rule which exempts debt of natural persons from the deemed sale or exchange rule applicable to debt of other taxpayers. The Committee believes that the debt of natural persons and other taxpayers is sufficiently economically similar to be similarly taxed upon their retirement. Accordingly, the Committee believes 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 bill extends to all types of property the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

By definition, the extension of the "sale or exchange rule" of present law section 1234A to all property will only affect property that is not personal property which is actively traded on an established exchange. Thus, the Committee bill will apply to (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 Committee bill is the tax treatment of amounts received to release a lessee from a requirement that the premise be restored on termination of the lease.[13] An example of the second type of property interest that is affected by the Committee bill is the forfeiture of a down payment under a contract to purchase stock.[14] The Committee bill does not affect whether a right is "property" or whether property is a "capital asset."

Character of gain or loss on retirement of debt obligations issued by natural persons.—The Committee bill repeals the provision that exempts debt obligations issued by natural persons from the rule which treats gain or loss realized on retirement of the debt as gain or loss realized on an exchange. Thus, under the bill, gain or loss on the retirement of such debt will be capital gain or loss. The provision retains the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

[13] 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).

[14] See *U.S. Freight Co.* v. *U.S.* 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

Effective Date

Extension of relinquishment rule to all types of property.—The extension of the extinguishment rule applies to property acquired or positions established 30 day after the date of enactment of the provision.

Character of gain or loss on retirement of debt obligations issued by natural persons.—The repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, applies to purchases and debt issued 30 days after date of enactment of the provision.

6. Determination of original issue discount where pooled debt obligations subject to acceleration (sec. 1005 of the bill and sec. 1272 of the Code)

Present 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 incudes 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 present law provide that, in such instances, the holder of the debt may assume that the debtors will remit their balances in a timely manner and thus avoid the interest charges. In a the case of a large pool of such debt instruments, this prepayment assumption, as applied to all debtors in the pool, is unrealistic and may result in the mismeasurement of income with respect to the interest charged to those debtors that do not prepay their account balances.

Explanation of Provision

The bill 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 accelerated by reason of prepayments. Thus, under the bill, 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 such year end, the taxpayer may accrue interest based on its actual experience rather than based upon reasonable assumptions.

The bill operates as follows. Assume that a calendar year taxpayer issues credit cards, the terms of which provide that if charges for a calendar month are paid within 30 days after the close of the month, no interest will accrue with respect to such charges. However, if the balances are not paid within this 30-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 card holders incur charges of $10 million in December 1997. Under present law (depending upon the taxpayer's accounting method), the taxpayer is not required to include any interest income in 1997 with respect to the December charges because it is possible that all the credit card holders will pay off the $10 million cumulative December balance by January 30, 1998, and therefore will not be subject to interest with respect to such charges. If some of the credit card holders do not pay their December charges by January 30, 1998, the balances of those holders will be subject to interest charges under the terms of the credit cards and the taxpayer would accrue such interest in income in 1998. Under the bill, the taxpayer, in computing its 1997 taxable income, would be required to make a reasonable assumption as to what portion of the $10 million balances will not be paid off within the 30-day grace period and would be required to accrue interest income through December 31, 1997, with respect to such portion. The taxpayer would then adjust such accrual in 1998 to reflect the extent to which such prepayment assumption reflected the actual payments received in January.

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. If a taxpayer is required to change its method of accounting under the bill, such change would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment would be 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 bill and have asked the Secretary of the Treasury for permission to change to a different method for pre-effective date years. So as not to require taxpayers to change methods of accounting multiple times, it is expected that the Secretary would not grant these pending requests.

7. Deny interest deduction on certain debt instruments (sec. 1006 of the bill and sec. 163 of the Code)

Present 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 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 Committee is 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 bill, 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 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 designed 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 bill does not affect the treatment of a holder of an instrument.

The bill is not intended to affect the characterization of instruments as debt or equity under present law; and no inference is intended as to the treatment of any instrument under present 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.

B. CORPORATE ORGANIZATIONS AND REORGANIZATIONS

1. Require gain recognition for certain extraordinary dividends (sec. 1011 of the bill and sec. 1059 of the Code)

Present 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.[15] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[16]

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 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.[17] Some taxpayers may argue that certain op-

[15] See H Rept. 99–841, II–166, 99th Cong. 2d Sess. (September 18, 1986).

[16] See Treas. reg. sec. 1.701–2(f), Example (2).

[17] 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. Al and All (April 7, 1995); Sloan,

Continued

tions 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 bill, 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.[18]

In addition, the bill 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 would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

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.[19] However, in applying the new gain recognition rules to any dis-

"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).

[18] 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.

[19] 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 of gain at the time of such sale or disposition.

tribution 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 present law of any transaction within the scope of the provision, including transactions utilizing options.

In addition, no inference is intended regarding the rules under present 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.

2. Require gain recognition on certain distributions of controlled corporation stock (sec. 1012 of the bill and secs. 355, 351(c), and 368(a)(2)(H) of the Code)

Present 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. (Sections 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).[20] Present law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company involved is the controlled corporation rather than the distributing corporation.

[20] If a controlled corporation is acquired after a distribution, an issue may arise whether under step-transaction concepts, the acquisition can be viewed 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 has indicated that it will 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; see also Rev. Rul. 96–30, 1996–1 C.B. 36; Rev. Rul. 70–225, 1970–1 C.B. 80.

Reasons for Change

The Committee believes 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 Committee is also 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.[21] Such intra-group distributions can also generally have the effect of permitting possibly 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.

However, the Committee believes 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.

Explanation of Provision

The bill adopts additional restrictions under section 355 on acquisitions and dispositions of the stock of the distributing or controlled corporation.

Under the bill, if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired, gain is recognized by the other corporation as of the date of the distribution.

In the case of an acquisition of a controlled corporation, the amount of gain recognized by the distributing corporation is the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. In the case of an acquisition of the distributing corporation, the amount of gain recognized by the controlled corporation is the amount of net gain that the distributing corporation would have recognized had it sold its assets for fair market value immediately after the distribution. This gain 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.

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

[21] Excess loss accounts in consolidation generally are created when a parent corporation derives a benefit in the form of a distribution, or the use of otherwise unavailable losses, that exceed the basis of the parent in the stock of the subsidiary providing the benefit. In general, such excess benefits in consolidation are permitted to be deferred rather than causing immediate taxable gain. Nevertheless, 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-up prior to a 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 distributing from the subsidiary is structured to meet the form of a section 355 distribution.

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. 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 bill proposal requires gain recognition by the corporation not acquired. 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. However, 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.

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 bill 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 bill does not apply to a distribution pursuant to a title 11 or similar case.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the proposal, including regulations to provide for the application of the proposal in the case of multiple transactions.

Except as provided in regulations, in the case of distributions of stock within an affiliated group of corporations filing a consolidated return, section 355 does not apply to any distribution of the stock of one member of the group to another member. In the case of such a distribution of stock, the Secretary of the Treasury is to provide appropriate rules for the treatment of the distribution, including rules governing adjustments to the adjusted basis of the stock and the earnings and profits of the members of the group.

The bill 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 50 percent or greater interest in the vote and value of stock of the distributed corporation.

The bill 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 proposal 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 would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Effective Date

The bill is generally effective for distributions after April 16, 1997. However, the part of the bill providing a 50-percent control requirement immediately after certain section 351 and 368(a)(1)(D) distributions will be effective for transfers after the date of enactment.

No part of the bill will apply to a distribution (or transfer, as the case may be) after April 16, 1997, if such distribution or transfer is (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 on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution. Any written agreement, ruling request, or public announcement is not within the scope of these transition provisions unless it identifies the unrelated acquiror of the distributing corporation or of any controlled corporation, whichever is applicable.

3. Reform tax treatment of certain corporate stock transfers (sec. 1013 of the bill and secs. 304 and 1059 of the Code)

Present 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.

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. There 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 presence 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.

As one 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. Under present law, the transfer is treated as a redemption of shares of B, which redemption is treated as 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. Taxpayers may contend 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 corporation, the domestic corporation may take 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 bill, 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, 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 bill 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 bill, a special rule applies to section 304 transactions involving acquisitions by foreign corporations. The bill 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 present 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 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.

4. Modify holding period for dividends-received deduction (sec. 1014 of the bill and sec. 246(c) of the Code)

Present 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

Under present law, 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 Committee believes 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 bill 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 provision is effective for dividends paid or accrued after the 30th day after the date of the enactment of the bill.

C. OTHER CORPORATE PROVISIONS

1. Registration of confidential corporate tax shelters and substantial understatement penalty (sec. 1021 of the bill and secs. 6111 and 6662 of the Code)

Present 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 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 improve 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 provision 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 provision 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 multi-party 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 taxwriting 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.

2. Treat certain preferred stock as "boot" (sec. 1022 of the bill and secs. 351, 354, 355, 356 and 1036 of the Code)

Present Law

In reorganization transactions within the meaning of section 368 and certain other retructurings, 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 can be received tax-free in a reorganization. Upon the receipt of "other property," gain but not loss can be 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 debt-for-debt rule, similar rules generally apply to transactions described in 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 a preferred stock. The acquiring corporation contributes cash to a holding company, which uses the cash to acquire the stock of the other shareholders. In the final acquisition structure, the shareholder who received the preferred stock may also have the additional benefit that the holding company, in which the shareholder now owns preferred stock, may itself own highly secure investments. (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 obtains a basis step-up and never recognizes 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 Committee believes that when such preferred stock instruments are received in certain exchange transactions, it is appropriate to view such instruments as taxable consideration since the investor has often obtained a more secure form of investment.

Explanation of Provision

The bill 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 but not loss is recognized.

The bill applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, 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 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). For this purpose, the rules of (1), (2), and (3) apply 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, 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 publicly traded, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder. 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.

The following exchanges are excluded from this gain recognition: (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. For this purpose, 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.

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 this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in 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.

D. ADMINISTRATIVE PROVISIONS

1. Reporting of certain payments made to attorneys (sec. 1031 of the bill and sec. 6045 of the Code)

Present 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 provision will have 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 is 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 provision 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 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).

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.

2. Information reporting on persons receiving contract payments from certain Federal agencies (sec. 1032 of the bill and sec. 6041A of the Code)

Present 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

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 provision 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 recipient 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.

3. Disclosure of tax return information for administration of certain veterans programs (sec. 1033 of the bill and sec. 6103 of the Code)

Present Law

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

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, 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

It is appropriate to permit disclosure of otherwise confidential tax information to ensure the correctness of government benefits payments.

Explanation of Provision

The provision permanently extends the DVA disclosure provision.

Effective Date

The provision is effective on the date of enactment.

4. Establish IRS continuous levy and improve debt collection (secs. 1034, 1035, and 1036 of the bill and secs. 6331 and 6334 of the Code)

a. Continuous levy

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand[22] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[23] 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.[24]

In general, a levy does not apply to property acquired after the date of the levy,[25] 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.[26] The only exception to this rule is for salary and wages.[27] 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.[28] It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which

[22] 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).

[23] Code sec. 6331.

[24] Code secs. 6335–6343.

[25] Code sec. 6331(b).

[26] Code sec. 6331(c).

[27] Code sec. 6331(e).

[28] Code sec. 6334(a)(9).

the taxpayer is entitled, divided by 52.[29] For a family of four for taxable year 1996, the weekly minimum exemption is $325.[30]

Reasons for Change

The extension of the continuous levy provisions will substantially ease the administrative burdens of collecting taxes by levy. The Committee anticipates 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 provision 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 provision 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 bill 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.

Effective Date

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

b. Modifications of levy exemptions

Present Law

The Code exempts from levy workmen's compensation payments[31] and annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act[32] described above, unemployment benefits[33] and means-tested public assistance.[34]

Reasons for Change

The Committee believes that if wages are subject to levy, wage replacement payments should also be subject to levy. In addition, the Committee believes that it is inappropriate to exempt from levy

[29] Code sec. 6334(d).

[30] Standard deduction of $6,700 plus four personal exemptions at $2,550 each equals $16,900, which when divided by 52 equals $325.

[31] Code sec. 6334(a)(7).

[32] Code sec. 6334(a)(6).

[33] Sec. 6334(a)(4).

[34] Sec. 6334(a)(11).

one type of annuity or pension payment while most other types of these payments are subject to levy.

Explanation of Provision

The provision 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.

5. Consistency rule for beneficiaries of trusts and estates (sec. 1037 of the bill and sec. 6034A of the Code)

Present 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, rules comparable to the consistency rules that apply to S corporation shareholders and partners in partnerships are 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 Committee believes that it is appropriate to apply such requirement also to beneficiaries of estates and trusts.

Explanation of Provision

Under the bill, 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 date of enactment.

E. EXCISE TAX PROVISIONS

1. Extension and modification of Airport and Airway Trust Fund excise taxes (sec. 1041 of the bill and secs. 4081, 4091, and 4261 of the Code)

Present Law

Present law imposes a variety of excise taxes on air transportation 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 has 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. Each of the Airport and Airway Trust Fund excise taxes is scheduled to expire after September 30, 1997.

Commercial air passenger transportation taxes

Domestic air passenger transportation is subject to an ad valorem excise tax equal to 10 percent of the amount paid for the transportation. Taxable domestic air transportation includes both travel within the United States and 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").

International air passenger transportation is subject to a $6 departure excise tax imposed on passengers departing the United States for other countries. No tax is imposed on passengers arriving in the United States from other countries. International transportation is defined to include separate domestic flights that connect to international flights, provided that stopover time at any point within the United States does not exceed 12 hours. Thus, 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 10-percent ad valorem excise tax otherwise imposed on such transportation between two domestic points.

Because both the domestic and international air passenger excise taxes are imposed only on transportation for which an amount is paid, no tax is imposed on "free" travel (e.g., frequent flyer travel and airline industry employee travel for which the passenger is not directly charged) even if third parties (e.g., credit card companies) make cash or in kind payments for the right to award the "free" or reduced-rate travel to their customers.

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. In general, both the domestic and international air passenger transportation excise taxes are imposed without regard to whether the transportation is purchased within the United States. An exception provides that travel between the United States and the 225-mile zone is subject to the ad valorem domestic tax 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 airline 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 collected from a passenger must be stated separately on the ticket.

Commercial air cargo transportation

Domestic air cargo transportation is subject to a 6.25-percent ad valorem excise tax. This tax, like the air passenger 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. The current Airport and Airway Trust Fund tax rates on these fuels are 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 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

Fuels used in air transportation are subject to a 4.3-cents-per-gallon excise tax, receipts from which are retained in the General Fund. This fuels tax is identical 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, 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. 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 amounts deemed collected during the second 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 Committee determined that provisions to ensure a long-term, stable funding source for the Airport and Airway Trust Fund should be enacted at this time. As illustrated by the recent events when a shortfall in fiscal year 1997 FAA funding was narrowly averted by an emergency extension of the present-law excise taxes through September 30, 1997, longer-term assurance of these funding needs is imperative. Therefore, the bill extends (with certain modifications) the current Airport and Airway excise taxes for a 10-year period, a move that is believed will resolve, for this period, concerns about the availability of adequate user tax revenues to fund the portion of FAA programs to be appropriated from the Airport and Airway Trust Fund.

The Committee determined limited modifications to the current passenger excise tax structure are warranted. First, the structure of the tax is modified to include a reduced ad valorem rate and a fixed dollar amount tax rate applicable to all revenue passengers. In addition, the Committee determined that the perceived fairness of the passenger air transportation excise taxes will be improved if certain currently untaxed payments and passengers were required to contribute to the financing of the FAA programs from which they benefit. In furtherance of this goal, the bill extends the tax to internationally arriving passengers and clarifies that the tax applies to payments to airlines (and related parties) from credit card and other companies in exchange for the right to award frequent flyer or other reduced air travel rights.

Explanation of Provision

Extension of Airport and Airway Trust Fund taxes

The Airport and Airway Trust Fund excise taxes, as modified below, are extended 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.

Modification of commercial air passenger transportation taxes

Modify tax rates.—The current 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 $2.00 fixed dollar amount per flight segment. The fixed dollar amount per flight segment will be increased each January 1 for a four-year period, as follows:

	Per flight segment charge
Calendar year:	
1999	$2.25
2000	2.50
2001	2.75
2002	3.00

Beginning on January 1, 2003, and 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.[35] The bill provides that there is no change in the number of flight segments for which a passenger is charged (increase or decrease) in the case of transportation routing changes initiated by the air carrier, provided there is no change in the fare charged. 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 seg-

[35] For example, travel from New York to San Francisco, with an intermediate stop in Chicago, would consist of two flight segments (without regard to whether the passenger changed aircraft in Chicago).

ments associated with international transportation, is subject to tax at the 7.5 percent and $2.00 rates.

The current $6 international departure tax is increased to $15.50 per departure, and an identical $15.50 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.

As under present law, certain air transportation between the United States and points within the 225-mile zone of Canada or Mexico is taxed as domestic transportation subject to the 7.5 percent and $2.00 rates. The present-law rules classifying transportation between the 48 contiguous States and Alaska or Hawaii (or between those States) as part domestic and part international are retained, without change, other than a clarification that a single flight segment between the 48 contiguous States and Alaska or Hawaii (or between those States) is subject to only one $15.50 per passenger international tax despite the fact that the flight both departs into and arrives from international airspace.

Extension of tax to certain currently exempt passengers.—As described above, passengers arriving in the United States from other countries, who currently are the only group of travelers whose transportation is subject neither to an excise tax nor a user fee for U.S.-provided aviation services, are subject to tax on their arriving international flights.

Clarification further is provided 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. Examples of such taxable amounts include (1) payments for frequent flyer miles purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, and other businesses for distribution to their customers and others and (2) amounts received by airlines pursuant to joint venture credit card or other marketing arrangements. 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 7.5-percent tax is applied. No inference is intended from this provision as to the proper treatment of these payments under present law.

Advertising requirements.—The Code advertising requirements are modified to mandate that the Federal air transportation tax be stated separately. The tax must be stated proximate to the airfare in type at least 50 percent as large as the fare is stated, and be identified as a user tax as required under present law.

Liability for tax.—The present-law provision imposing liability for the tax on passengers (with transportation providers being liable for collecting and remitting revenues to the Federal Government) are modified to impose secondary liability on air carriers. As with the current tax, the aggregate tax will continue to be required to be stated separately on passenger tickets.

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 payment of these 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.

Effective Date

These provisions generally are effective on the date of enactment, for air transportation beginning after September 30, 1997.

Present law requires transportation providers to continue collecting the commercial aviation excise taxes (at the current rates) on transportation to be provided after September 30, 1997, if the transportation is purchased before October 1, 1997. The bill requires transportation providers to collect the taxes at the modified rates for transportation purchased after the date of enactment for travel beginning 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 clarifying application of the commercial air passenger excise tax 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 provisions transferring certain General Fund fuels tax revenues and modifying the commercial air passenger excise tax deposit rules are effective on the date of enactment.

2. Extend diesel fuel excise tax rules to kerosene (sec. 1042 of the bill and sec. 4081–4083 of the Code)

Present Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.3 cents per gallon. 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 refund claims if undyed diesel fuel is used in a qualifying use.

Aviation gasoline and jet fuel (both commercial and noncommercial use) currently are 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 are subject to an additional 15-cents-per- gallon rate (gasoline) and 17.5-cents-per-gallon rate (jet fuel) for the Airport and Airway Trust Fund. These combined rates produce an aggregate tax of 21.8 cents per gallon on noncommercial aviation jet fuel and 19.3 cents per gallon on noncommercial aviation gasoline. 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.

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 periods 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 Internal Revenue Service has discovered significant evidence that kerosene is 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 have suggested that their competitors have not been paying the tax on the kerosene that they blend 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 have significantly reduced opportunities to evade that tax. The Committee determined therefore, that these same compliance measures should be extended to kerosene.

Explanation of Provision

The diesel fuel-excise tax rules are extended to kerosene. Thus, kerosene is be 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 is not subject to the dyeing requirement and would be taxed under the 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 would be 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.

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.

3. Modify tax benefits for ethanol and renewable source methanol (sec. 1043 of the bill and secs. 40, 4041, 4081, 4091, and 6427, and new sec. 4476 of the Code)

Present Law

Present law provides a 54-cents-per-gallon income tax credit for ethanol and a 60-cents-per-gallon income tax credit for methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. As an alternative to claiming the income tax credits directly, these tax benefits may be claimed as a reduction in the amount of excise tax paid on gasoline or diesel fuel with which the ethanol or renewable source methanol are blended or as a reduction in the special motor fuels rate applicable to "neat" ethanol or renewable source methanol fuels. The excise tax delivery of the benefits occurs either through reduced tax rate sales to registered blenders of e.g., gasoline or diesel fuel, or through expedited refunds of gasoline or diesel fuel tax paid.

In addition to these general ethanol benefits, a separate 10-cents-per-gallon credit is provided for small ethanol producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. No comparable small producer credit is provided for small renewable source methanol producers.

Treasury Department regulations provide that ethyl tertiary butyl ether ("ETBE"), which is made using ethanol, qualifies for the blender income tax credit and the excise tax exemption.

The alcohol fuels tax benefits are scheduled to expire after December 31, 2000. The provision allowing the ethanol blender benefits to be claimed through the motor fuels excise tax system is scheduled to expire after September 30, 2000.

Reasons for Change

The ethanol tax subsidies originally were enacted in 1978 to promote development of alternative fuels at a time when oil prices were projected to exceed $50 per barrel. The benefits were assumed to be temporary measures that would allow these fuels to become economical without permanent Federal subsidies. Nearly 20 years have passed since that enactment, and neither the projected prices of oil nor the ability of ethanol to be a viable fuel without Federal subsidies has been realized. The Committee determined, therefore, that enactment of an orderly termination of this Federal subsidy program is appropriate at this time.

Explanation of Provision

The bill retains the current blender ethanol (at a reduced level) and renewable source methanol benefits through their scheduled expirations in 2000, but limits the amount of production of these fuels eligible for tax benefits. The bill also clarifies that ETBE and similar ethers are not eligible for the alcohol fuel tax benefits.

Limit on production eligible for tax benefits

The alcohol fuels income tax credits (other than the small ethanol producer tax credit) and the excise tax exemptions for ethanol and methanol from renewable sources will be available only for alcohol fuels produced by distilling equipment placed in service before June 9, 1997.[36] Additionally, producers other than small producers (defined as under present law) will receive these benefits only to the extent that annual production after December 31, 1997, does not exceed average annual production of fuel alcohol by the equipment during a prescribed three-year period (the "eligible production ceiling"). The eligible production ceiling is determined first by ascertaining annual production during each year of the five-year period ending on May 31, 1997. The year when production was the greatest and the year when production was the lowest are eliminated. The production ceiling equals the average of the annual production during the remaining three years. A safe-harbor production level equal to 50 percent of capacity as of June 8, 1997, is provided.

To ensure that only eligible production continues to receive the blender tax benefits after the date of the bill's enactment, an "excess production penalty" is imposed on all production from equipment placed in service after June 8, 1997, and on production from existing equipment (by producers other than small producers) that exceeds the producer's eligible production ceiling. Beginning on January 1, 2001, all ethanol production will be treated as "excess" production, but the penalty will not apply during any period when no ethanol or renewable source methanol tax benefits are statutorily available. The penalty is non-deductible for Federal income tax purposes. Receipts from the penalty will be deposited in the Highway Trust Fund. The penalty offsets the benefit provided to

[36] Property placed in service after June 8, 1997, pursuant to a binding contract entered into before June 9, 1997, would be treated as if placed in service before June 9, 1997.

excess production by the current general income tax and excise tax provisions; therefore, no changes (other than those described herein) are made to those provisions. Thus, blenders will remain eligible to claim the tax benefits in the same manner as provided under present law, through 2000.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers

Carbon dioxide is a naturally occurring by-product of ethanol production. This carbon dioxide is commercially valuable and currently is being captured and sold by ethanol producers. The 54-cents-per-gallon ethanol income tax credit and the 5.4-cents-per-gallon ethanol excise tax exemptions are reduced to 51 cents per gallon and 5.1 cents per gallon, respectively, to reflect the value of carbon dioxide recovered as a by-product in ethanol production.

The present-law small ethanol producers credit is increased from 10 cents per gallon to 13 cents per gallon to offset the effect of this reduction for small producers.

ETBE and similar ethers not to qualify

Statutory clarification is provided that ETBE and similar ethers (and alcohol used to produce these ethers) are not qualified alcohol fuels for either the ethanol or methanol from renewable sources tax benefits.

Effective Date

Limit on eligible production

The provision limiting production eligible for the alcohol fuels tax benefits to production from facilities placed in service before June 9, 1997, is effective on the date of enactment. The production limits applicable to such grandfathered facilities is effective for production occurring after December 31, 1997.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value

The reduction in the ethanol blenders credit and excise tax exemption to reflect the value of carbon dioxide produced as a by-product and the offsetting increase in the small producer's income tax credit are effective on January 1, 1998.

ETBE and similar ethers not to qualify

The provision reversing the Treasury Department regulations defining ethers as qualified alcohol fuels is effective for ethers produced after December 31, 1997.

4. Reinstate Leaking Underground Storage Tank Trust Fund excise tax (sec. 1044 of the bill and secs. 4041(d), 4081(a)(2), and 4081(d)(2) of the Code)

Present 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 Committee determined that the Leaking Underground Storage Tank Trust Fund excise tax should be reinstated for a 5-year period to ensure the availability of funds to pay cleanup costs of leaking underground storage tanks.

Explanation of Provision

The bill reinstates for a 5-year period the prior-law Leaking Underground Storage Tank Trust Fund excise tax.

Effective Date

The provision is effective on the date of enactment.

5. Application of communications tax to long-distance prepaid telephone cards (sec. 1045 of the bill and sec. 4251 of the Code)

Present 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 Committee understands that communication service providers sometimes sell units of long-distance service to third parties who, in turn, resell or distribute these units of long-distance telephone service to the ultimate customer in the form of prepaid telephone cards or similar arrangements. The Committee believes that such payments clearly represent payments for long-distance telephone service and clarifies that such payments are subject to the communications excise tax.

Explanation of Provision

The bill provides that any amounts paid to communications service providers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate long-distance telephone service are treated as amounts paid for taxable communication 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 communication service providers pursuant to joint venture credit card or other marketing arrangements. 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. No inference is intended from this provision as to the proper treatment of these payments under present law.

Effective Date

The provision is effective for amounts paid on or after the date of enactment.

F. PROVISIONS RELATING TO TAX-EXEMPT ENTITIES

1. Extend UBIT rules to second-tier subsidiaries and amend control test (sec. 1051 of the bill and sec. 512(b)(13) of the Code)

Present Law

In general, interest, rents, royalties and annuities are excluded from unrelated taxable business income (UBTI) of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBTI if such income is received from a taxable or tax-exempt subsidiary that is 80 percent controlled by the parent tax-exempt organization.[37] 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.[38] In the case of a non-stock 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.[39]

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.[40] Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBTI to the tax-exempt parent organization.[41]

Reasons for Change

Section 512(b)(13) was enacted 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. 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 brother/sister subsidiaries. The Committee believes that

[37] For this purpose, a "controlled organization" is defined under section 368(c). Under present law, rent, royalty. annuity, and interest payments are treated as UBTI when received by the parent organization based on the percentage of the subsidiary's income that is UBTI (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).

[38] Treas. reg. sec. 1.512(b)–1(1)(4)(I)(a).

[39] Treas. reg. sec. 1.512(b)–1(1)(4)(I)(b).

[40] 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 UBTI 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 precent 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.

[41] 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 UBTI).

the modifications to the control requirement and inclusion of attribution rules will ensure that section 512(b)(13) operate consistent with its intended purpose.

Explanation of Provision

The bill modifies the test for determining control for purposes of section 512(b)(13). Under the bill, "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 bill 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 bill 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 includible in the latter organization's UBTI. 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 modification of the control test to one based on vote or value, the application of the constructive ownership rules of section 318, and the technical modifications to the flow-through method apply to taxable years beginning after the date of enactment. The reduction of the ownership threshold for purposes of the control test from 80 percent to more than 50 percent applies to taxable years beginning after December 31, 1998.

2. Limitation on increase in basis of property resulting from sale by tax-exempt entity to related person (sec. 1052 of the bill and sec. 1061 of the Code)

Present Law

If a tax-exempt entity transfers assets to a controlled taxable entity in a transaction that is treated as a sale, the transferee taxable entity obtains a fair market value basis in the assets. Because the transferor is tax-exempt, no gain is recognized on the transfer except to the extent of certain unrelated business taxable income, if any.

Other provisions of the Code deny certain tax benefits when a transferor and transferee are related parties. For example, losses on sales between related parties are not recognized (sec. 267).

Reasons for Change

The Committee recognizes that a tax-exempt entity can sell assets to a taxable party without recognition of gain, while that party receives a fair market value basis in the property. However, the

Committee is concerned that tax-exempt entities may in effect structure transactions in which assets are transferred to taxable entities controlled by the tax-exempt entity, in a form such that a stepped-up basis and depreciation are available to reduce the amount that would otherwise have been taxable unrelated business income, if the tax-exempt entity had converted the same assets to taxable operation and operated the business itself.

Explanation of Provision

In the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property will not exceed the adjusted basis of such property immediately before the sale in the hands of the tax-exempt entity, increased by the amount of any gain recognized to the tax-exempt entity under the unrelated business taxable income rules of section 511.

A related person means any person having a relationship to the tax-exempt entity described in section 267(b) or 707(b)(1) (generally, certain more-than-50-percent relationships, with specified attribution rules). For purposes of applying section 267(b)(2), such an entity is treated as if it were an individual.

Effective Date

The provision applies to sales or exchanges after June 8, 1997; except that it will not apply to a sale or exchange made pursuant to a written agreement which was binding on such date and at all times thereafter.

3. Reporting and proxy tax requirements for political and lobbying expenditures of certain tax-exempt organizations (sec. 1053 of the bill and sec. 6033(e) of the Code)

Present Law

Section 162(e) denies deductions as a trade or business expense for certain lobbying and political expenditures. Section 162(e)(3) provides a flow-through rule to disallow a deduction for a portion of membership dues or similar payments paid to a tax-exempt organization if the organization notifies the member under section 6033(e) that such portion of the membership dues is allocable to political or lobbying activities engaged in by the organization.

Under section 6033(e), tax-exempt organizations (other than charities described in section 501(c)(3)) that engage in lobbying or political campaign activities must disclose the amount of members' dues allocable to lobbying or political campaign expenditures to their members and to the Internal Revenue Service (IRS), except for certain in-house, de minimis expenses.[42] If an organization fails to meet the disclosure requirement under section 6033(e), then the organization generally is subject to a so-called "proxy tax" equal to 35 percent of the amount of members' dues allowable to lobbying or political campaign expenditures. However, under section

[42] Such disclosure is not required, however with respect to political expenditures if tax is imposed on the organization with respect to such expenditures under section 527(f) (see sec. 6033(e)(1)(B)(iii)).

6033(e)(3), organizations are exempt from the disclosure requirements and proxy tax if they can establish to the satisfaction of the Secretary of the Treasury that substantially all dues or other similar amounts received by the organization are not deductible without regard to whether or not the organization conducts lobbying or political campaign activities. In Rev. Proc. 95–35, the IRS announced that all tax-exempt organizations—other than (1) organizations described in section 501(c)(4) that are not veterans organizations, (2) agricultural and horticultural organizations described in section 501(c)(5), and (3) trade associations and other organizations described in section 501(c)(6)—are deemed automatically to qualify for the section 6033(e)(3) exemption from the general disclosure requirements and proxy tax. Rev. Proc. 95–35 further provides that an organization described in section 501(c)(4) or an agricultural or horticultural organization described in section 501(c)(5) qualified for the section 6033(e)(3) exemption if the organization receives at least 90 percent of its dues from (a) members with annual dues of less than $50 or (b) other tax-exempt organizations. Under Rev. Proc. 95–35, a trade association or other organization described in section 501(c)(6) qualifies for the section 6033(e)(3) exemption if the organization receives at least 90 percent of its dues from other tax-exempt organizations.[43]

Reasons for Change

The Committee believes that it is appropriate to modify present-law section 6033(e) to ensure that tax-exempt organizations (other than charities and organizations that receive annual dues of less than $100) do not use tax-deductible dues payments to fund lobbying or political activities, the costs of which would not be deductible for Federal income tax purposes if incurred directly by members of the organization.

Explanation of Provision

Section 6033(e)(3) is amended to provide that an exemption from the general disclosure requirements and proxy tax of section 6033(e) is available to a tax-exempt organization if more than 90 percent of the amount of aggregate annual dues (or similar payments) received by the organization are paid by (1) individuals or families whose annual dues (or similar amounts) are less than $100,[44] or (2) tax-exempt entities. For purposes of the provision, all organizations sharing a name, charter, historic affiliation, or similar characteristics and coordinating their activities would be treated as a single entity. As under present law, charities described in section 501(c)(3) are not subject to the section 6033(e) disclosure requirements and proxy tax.

[43] In addition, Rev. Proc. 95–35 provides that any organization may establish that it satisfies the section 6033(e)(3) exemption by (1) maintaining records establishing that 90 percent or more of the annual dues paid to the organization are not deductible without regard to whether or not the organization conducts lobbying or political campaign activities, and (2) notifying the IRS that it is described in section 6033(e)(3) on any Form 990 (i.e., annual information return) that is required to file. Additionally, an organization may request a private letter ruling that the organization is eligible for the section 6033(e)(3) exemption.

[44] The $100 amount will be indexed for inflation after December 31, 1997 (rounded to the nearest multiple of $5).

Effective Date

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

4. Repeal grandfather rule with respect to pension business of certain insurers (sec. 1054 of the bill and sec. 1012(c) of the Tax Reform Act of 1986)

Present 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 organizations 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 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 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 does 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 Committee is concerned that the continued tax-exempt status of certain organizations that engage in insurance activities gives such organizations an unfair competitive advantage. The Committee believes that the provision of insurance at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial. Thus, the Committee believes, it is 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 provision repeals the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association-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 or for other purposes).

Effective Date

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

G. OTHER REVENUE-INCREASE PROVISIONS

1. Phase out suspense accounts for certain large farm corporations (sec. 1061 of the bill and sec. 477 of the Code)

Present 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 decline 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 is required to be included in gross income.

Reasons for Change

The Committee believes 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 Committee believes 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 so subject. In addition, the Committee believes 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 Committee recognizes that requiring the recognition of previously established suspense accounts may impose liquidity concerns upon some farm corporations. Thus, the Committee provides an extended period over which existing suspense accounts must be restored to income and provides further deferral where the corporation has insufficient income for the year.

Explanation of Provision

The bill 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 bill, 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 present-law requirements to restore such accounts more rapidly. 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 bill. 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 pursuant to present law.

Effective Date

The provision is effective for taxable years ending after June 8, 1997.

2. Modify net operating loss carryback and carryforward rules (sec. 1062 of the bill and sec. 172 of the Code)

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may 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).

Reason for Change

The Committee recognizes 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 Committee believes 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 bill).

Explanation of Provision

The bill limits the NOL carryback period to two years and extends the NOL carryforward period to 20 years. The bill does not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses. In addition, the bill does not apply to NOLs arising from casualty losses of individual taxpayers.

Effective Date

The provision is effective for NOLs arising in taxable years beginning after the date of enactment.

3. Expand the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts (sec. 1063 of the bill and sec. 264 of the Code)

Present 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").[45] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)).

Premium deduction limitation

No deduction is 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)).

[45] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 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 viatical settlement provider of a life insurance contract on the life of terminally ill or chronically ill individual, are treated as excludable as if paid of the death of insured (sec. 101(g)).

Interest deduction disallowance with respect to life insurance

Present law provides generally that 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 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 (the "COLI" rules).

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 contract.[46]

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.

The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.[47]

Interest deduction limitation with respect to tax-exempt interest income

Present law provides that 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

[46] Phase-in rules apply generally 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.

[47] 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) and 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 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 debt (the "4-out-of-7 rule") (sec. 264(a)(1)). In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

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)).[48]

Reasons for Change

The Committee understands 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 Committee understands 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 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 Committee bill 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 life insurance policy, or endowment or annuity contract, covering the life of any individual.

In addition, the Committee understands 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, annuity and endowment contracts.[49] The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other business 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 bill provides that, for taxpayers other than natural persons, no deduction is allowed

[48] Special rules apply for certain tax-exempt obligations of small issuers (sec. 265(b)(3)).

[49] 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.

for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender 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 present-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.

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 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 when the contract is first issued under applicable State law, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

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 so allocable 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 average adjusted bases for all assets of the taxpayer. This rule does not apply to any policy or contract owned by an entity engaged in a trade or business, covering any individual who is an employee, officer or director of the trade or business at the time first covered by the policy or contract. Such a policy or contract is not taken into account in determining 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).

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report the amount of the amount of the unborrowed cash value in order to carry out this rule.

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.

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.

Effective Date

The provisions apply with respect to contracts issued after June 8, 1997. For this purpose, a material increase in the death benefit or other material change in the contract causes the contract to be treated as a new contract. To the extent of additional covered lives under a contract after June 8, 1997, the contract is 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 applies, the contract is not treated as a new contract.

4. Allocation of basis of properties distributed to a partner by a partnership (sec. 1064 of the bill and sec. 732(c) of the Code)

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[50] 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 or not 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).

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules 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.

Present law provides for allocation in proportion to the partnership's adjusted basis. The rule allocates 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 partner-

[50] 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 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).

ship 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)).[51] Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds the partnership's basis in the property.

Reasons for Change

The rule providing that distributee partners allocate basis in proportion to the partnership's adjusted basis in the distributed property gives rise to problems in application.[52] The Committee is concerned that the present-law rule permits 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 Committee believes 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).

Under the provision, 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 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

[51] 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)). Tres. 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.

[52] "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), para. 19.06.

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.

5. Treatment of inventory items of a partnership (sec. 1065 of the bill and sec. 751 of the Code)

Present Law

Under present 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 law provides 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 both ineffective at insulating partnerships from the potential complexity of the disproportionate distribution rules of section 751(b), and also ineffective at properly treating income attributable to inventory as ordinary income under the section 751 rules for partnerships with profit margins below 20 percent.[53] Because the Committee believes that income attributable to inventory should be treated as ordinary income, the bill repeals the substantial appreciation requirement with respect to inventory, in the case of partnership sales, exchanges and distributions.

Explanation of Provision

The provision eliminates the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests and certain partnership distributions. This conforms the treatment of inventory to the treatment of unrealized receivables under these rules.

Effective Date

The provision is effective for sales, exchanges, and distributions after the date of enactment.

6. Treatment of appreciated property contributed to a partnership (sec. 1066 of the bill and secs. 704(c)(1)(B) and 737 of the Code)

Present 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

[53] 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]).

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 partnership is made within 5 years after the contribution of the appreciated property (sec. 737).

If a partnership distributes property to a partner, the partner does not recognize gain except to the extent any money (including marketable securities) received in the distribution exceeds the partner's basis for its partnership interest (sec. 731(a)). In addition, a partnership does not recognize gain on a distribution to a partner (sec. 731(b)).

Reasons for Change

The Committee is 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 Committee believes 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 10 years after the contribution of the appreciated property.

Explanation of Provision

The provision extends to 10 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 10 years after the contribution to the partnership.

Effective Date

The provision is effective for property contributed to a partnership after June 8, 1997.

7. Earned income credit compliance provisions (sec. 1067 of the bill and secs. 32, 6213(g) and 6695 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 rate by the individual's[54] 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

[54] 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.

PRESENT-LAW EARNED INCOME CREDIT PARAMETERS—Continued

	Two or more qualifying children	One qualifying child	No qualifying children
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.

a. Deny EIC eligibility for prior acts of recklessness or fraud (sec. 1067 of the bill and sec. 32 of the Code)

Present 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.

Reason for Change

The Committee believes 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

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

b. Recertification required when taxpayer found to be ineligible for EIC in past (sec. 1067 of the bill and secs. 32 and 6213(g) of the Code)

Present 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 claimed. 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 by 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.

Reason for Change

The Committee believes 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

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

c. Due diligence requirements for paid preparers (sec. 1067 of the bill and sec. 6695 of the Code)

Present Law

There are several penalties that 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.

Reason for Change

The Committee believes that more thorough efforts by return preparers are important to improving EIC compliance.

Explanation of Provision

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

8. Eligibility for income forecast method (sec. 1068 of the bill and secs. 167 and 168 of the Code)

Present 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. 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 other any property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the 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 is available to any property if (1) the taxpayer elects to exclude such property from MACRS and (2) for the first taxable year for which depreciation is allowable, the property is properly depreciated under such method. 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.[55] Most recently,

[55] 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.

the income forecast method has been held applicable to consumer durable property subject to short-term “rent-to-own” leases.[56]

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 Committee believes 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 Committee believes that the availability of the income forecast method should be limited to instances where the economic depreciation of the 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 Committee is concerned about taxpayer selectivity.

Finally, the Committee provides 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 bill clarifies the types of property to which the income forecast method may be applied. Under the bill, 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 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 fore-

[56] See, *ABC Rentals of San Antonio* v. *Comm.,* No. 95–9008 (10th Cir. 9/27/96), 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.,* No. 95–60301 (5th Cir., 1995) (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).

cast method). Such property generally is described in Rev. Proc. 95–38, 1995–34 I.R.B. 25.

Effective Date

The provision is effective for property placed in service after the date of enactment.

9. Require taxpayers to include rental value of residence in income without regard to period of rental (sec. 1069 of the bill and secs. 280A and 1016 of the Code)

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a de minimis exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Reasons for Change

The de minimis exception allows certain taxpayers to exclude from income large rental payments for the short-term rental of the taxpayer's residence. The Committee believes that such amounts generally should be included in income of the taxpayers.

Explanation of Provision

The bill repeals the 15-day rules of section 280A(g). The bill also provides that no reduction in basis is required if the taxpayer: (1) rented the dwelling unit for less than 15 days during the taxable year and (2) did not claim depreciation on the dwelling unit for the period of rental.

Effective Date

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

10. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts (sec. 1070 of the bill and sec. 1033 of the Code)

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time. 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 Committee believes 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 bill 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.

11. Repeal of exception for certain sales by manufacturers to dealer (sec. 1071 of the bill and sec. 811(c)(9) of the Tax Reform Act of 1986 (P.L. 99–514))

Present Law

In general, the installment sales method of accounting may not be used by dealers in personal property. Present law provides 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,[57] but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that gave rise to such receivables (the "fifty 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 be treat-

[57] I.e, the sale of the property must be intended to be for resale or leasing by the dealer.

ed as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test, the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables outstanding at the end of each month during the taxpayer's taxable year. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are 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 Committee believes that the special exception that permitted certain dealers to use the installment method is no longer necessary or appropriate and the installment sale method of accounting should not be available to such dealers. Accordingly, the Committee bill repeals that exception.

Explanation of Provision

The bill 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 after the date of enactment. Any resulting adjustment from a required change in accounting will be includible ratably over the 4-year taxable years beginning after that date.

TITLE XI. FOREIGN TAX PROVISIONS

A. GENERAL PROVISIONS

1. Eligibility of licenses of computer software for foreign sales corporation benefits (sec. 1101 of the bill and sec. 927 of the Code)

Present Law

Under special tax provisions that provide an export benefit, a portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of an FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of an 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 an FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to an 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 (Treas. Reg. sec. 1.927(a)–1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does 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 (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 are included within the definition of export property. In light of technological developments, the Committee believes that computer software is virtually indistinguishable from the enumerated films, tapes, and records. Accordingly, the Committee believes that the benefits of the FSC provisions similarly should be available to computer software.

Explanation of Provision

The bill 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 Committee intends 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 present law.

Effective Date

The provision generally 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. In the case of gross receipts attributable to 1998, the provision applies to only one-third of such gross receipts. In the case of gross receipts attributable to 1999, the provision applies to only two-thirds of such gross receipts.

2. Increase dollar limitation on section 911 exclusion (sec. 1102 of the bill and sec. 911 of the Code)

Present 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 for an uninterrupted period that includes an entire taxable year or (2) present overseas 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. The maximum exclusion for foreign earned income for a taxable year is $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 the credit that is attributable to excluded income.

Reasons for Change

The Committee recognizes 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 typically imposes additional financial burdens on the employee and his 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 Committee, therefore, believes 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 Committee further observes that the present-law $70,000 exclusion has remained unchanged for the past 10 years, while the extra costs from working abroad have increased with worldwide inflation. The Committee, therefore, believes it is 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 Committee believes it is 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 bill, 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 bill, 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.

3. Simplify foreign tax credit limitation for individuals (sec. 1103 of the bill and sec. 904 of the Code)

Present 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, this requires 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 is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Change

The Committee believes 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 Committee believes 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 bill 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 Committee intends that an individual electing this exemption will not be required to file 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.

4. Simplify translation of foreign taxes (sec. 1104 of the bill and secs. 905(c) and 986 of the Code)

Present 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

For taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. If a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arises. A foreign tax redetermination may occur in the case of a refund of foreign taxes. A foreign tax redetermination also may arise because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. In addition, a redetermination may 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 requires 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 Committee believes 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 Committee believes 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 Committee believes 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 Committee believes 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 Committee believes 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 bill 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 bill, 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 bill 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 bill, 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 bill 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. In cases where a redetermination is required, as under present law, the bill 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 tax credit pools in lieu of such a redetermination.

The bill provides that in the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, any such taxes if subsequently paid are taken into account for the taxable year to which such taxes relate. These taxes are translated into U.S. dollar amounts using the exchange rates in effect 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 the currency involved is not inflationary. Further assume that as of the end of year 1 the tax is unpaid. In this case, the bill 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.

5. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes (sec. 1105 of the bill and sec. 59 of the Code)

Present 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). Consequently, the allocation and apportionment of deductions must 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 have allocated and apportioned deductions for regular tax purposes generally must 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 Committee believes that permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation would provide an appropriate simplification of the necessary computations by eliminating the need to reallocate and reapportion every deduction.

Explanation of Provision

The provision 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 Committee intends that the foreign source taxable income in each such category generally would 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 Committee intends 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 alternative minimum tax or would be subject to the alternative minimum tax 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.

6. Simplify treatment of personal transactions in foreign currency (sec. 1106 of the bill 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 Committee believes 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 provision applies nonrecognition treatment to any resulting exchange gain, provided that such gain does not exceed $200. The provision does not change the treatment of resulting exchange losses. The Committee understands 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.

7. Simplify foreign tax credit limitation for dividends from 10/50 companies (sec. 1107 of the bill and sec. 904 of the Code)

Present 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.

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"). Dividends received by the taxpayer from each 10/50 company are subject to a separate foreign tax credit limitation.

Reasons for Change

The Committee finds that the present-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 Committee is 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 present-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 present 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."[58]

The Committee believes that the joint venture can be an efficient way for American business to exploit its know-how and technology in foreign markets. If the present-law limitation is discouraging such joint ventures or altering the structure of new ventures, the ability of American business to succeed abroad may be diminished. The Committee believes it is appropriate to modify the present-law limitation to promote simplicity and the ability of American business to compete abroad.

Explanation of Provision

Under the bill, a single foreign tax credit limitation generally applies to dividends received by the taxpayer from all 10/50 companies. However, separate foreign tax credit limitations continue to apply to dividends received by the taxpayer from each 10/50 company that qualifies as a passive foreign investment company. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earning and profits for periods prior to the taxpayer's acquisition of such stock. To the extent the regulations treat distributions from a foreign corporation out of earnings and profits for pre-acquisition periods as subject to a separate foreign tax credit limitation, it is expected that the regulations would allow the taxpayer to elect to apply that separate foreign tax credit limitation (rather than the limitation applicable to dividends from all 10/50 companies) also to distributions out of post-acquisition earnings and profits of such corporation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2001.

B. GENERAL PROVISIONS AFFECTING TREATMENT OF CONTROLLED FOREIGN CORPORATIONS (SECS. 1111–1113 OF THE BILL AND SECS. 902, 904, 951, 952, 959, 960, 961, 964, AND 1248 OF THE CODE)

Present 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 is not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead it generally is characterized as passive income.

For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, 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 and, except as provided in regu-

[58] 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.

lations, the recipient of the distribution was a U.S. 10-percent shareholder in such corporation.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10-percent shareholder, no provision of present law allows 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.

Reasons for Change

The Committee believes that complexities are caused by uncertainties and gaps in the present statutory schemes for taxing gains on dispositions of stock in CFCs as dividend income or subpart F income. The Committee believes that it is appropriate to reduce complexities by rationalizing these rules.

The Committee also understands 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 is concern that these limitations may have contributed to decisions by U.S. companies against acquiring foreign subsidiaries. The Committee deems it appropriate to ease these restrictions.

Explanation of Provision

Lower-tier CFCs

Characterization of gain on stock disposition

Under the bill, 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 bill, 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 income under the same-country exception that applies to actual dividends.

Under the bill, 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 bill makes clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The bill 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 bill, 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 bill, 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 bill, 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 proposal 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 bill, 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 bill 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 bill 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 bill limits the application of the indirect foreign tax credit below the third tier to taxes paid or incurred 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.

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 bill 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 paid or incurred by CFCs for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations, the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the bill, 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.

C. MODIFICATION OF PASSIVE FOREIGN INVESTMENT COMPANY PROVISIONS TO ELIMINATE OVERLAP WITH SUBPART F AND TO ALLOW MARK-TO-MARKET ELECTION (SECS. 1121–1123 OF THE BILL AND SECS. 1291-1297 OF THE CODE)

Present 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. 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, the 10-percent U.S. shareholders are 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 is of particular concern to the Committee. 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 apply to a U.S. shareholder that is subject to the current inclusion rules of subpart F with respect to the same corporation. The Committee believes that the additional complexity caused by this overlap is unnecessary.

The Committee also understands 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 can be achieved by providing an alternative income inclusion method for shareholders of PFICs. Further, some taxpayers have 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 Committee believes 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 bill 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). 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 proposal 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.

If, under the bill, 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 earnings 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.

Mark-to-market election

The bill 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 bill, 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 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 bill 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 bill 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, is 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 this bill 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.

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.

D. SIMPLIFY FORMATION AND OPERATION OF INTERNATIONAL JOINT VENTURES (SECS. 1131, 1141–1145, AND 1151 OF THE BILL AND SECS. 367, 721, 1491–1494, 6031, 6038, 6038B, 6046A, AND 6501 OF THE CODE)

Present Law

Under section 1491, an excise tax generally is 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 is 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 are available. Under section 1494(c), a substantial penalty applies 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. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the 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 Committee understands that the present-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 are satisfied operate as a trap for the unwary. The Committee further understands that the special source rule of present 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 Committee believes 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 bill repeals the sections 1491–1494 excise tax rules that apply to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applies under present 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. Instead of the excise tax that applies under present law to certain transfers to foreign corporations, regulatory authority is granted under section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not otherwise described in section 367. Instead of the excise tax that applies under present 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 bill repeals the rule that treats as U.S. source income any deemed royalty arising under section 367(d). Under the bill, 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 foreign partnership.

The bill provides detailed information reporting rules in the case of foreign partnerships. 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.

Under the bill, reporting rules similar to those applicable under present law 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 a more than 50 percent or greater interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership. 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 bill, the penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties.

Under the bill, 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 bill, the penalties for failure to report information with respect to a foreign corporation are conformed with these penalties.

Under the bill, reporting rules similar to those applicable under present law 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. Under the bill, the penalty under present law 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 bill, 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 to which such information relates not expire before the date that is three years after the date on which such information is provided.

Under the bill, regulatory authority is granted to provide rules treating a partnership as a foreign partnership where such treatment is more appropriate. It is expected that a recharcterization of a partnership as foreign rather than domestic 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 are effective upon date of enactment. The provisions with respect to the source of a deemed royalty under section 367(d) also are effective for transfers made and royalties deemed received after date of enactment.

The provisions regarding information reporting with respect to foreign partnerships generally are effective for partnership taxable years beginning after 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 interest in, foreign partnerships after 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 requirements is effective for information returns due after date of enactment.

The provision granting regulatory authority with respect to the treatment of partnerships as foreign or domestic is effective for partnership taxable years beginning after date of enactment.

E. MODIFICATION OF REPORTING THRESHOLD FOR STOCK OWNERSHIP OF A FOREIGN CORPORATION (SEC. 1146 OF THE BILL AND SEC. 6046 OF THE CODE)

Present 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. U.S. persons required to file these information returns are those who acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are 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 Committee believes that it is 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 Committee believes that increasing the threshold for such reporting from 5 percent to 10 percent will reduce the compliance burdens on taxpayers.

Explanation of Provision

The bill 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.

F. OTHER FOREIGN SIMPLIFICATION PROVISIONS

1. Transition rule for certain trusts (sec. 1161 of the bill and sec. 7701(a)(30) of the Code)

Present Law

Under rules enacted with 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. fiduciaries of the trust 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 Committee believes 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 bill, 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.

2. Simplify application of the stock and securities trading safe harbor (sec. 1162 of the bill and sec. 864(b)(2)(A) of the Code)

Present Law

A non-resident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the trade or business, at graduated rates of tax. 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 stock or securities. In addition, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is 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 stock and securities. In addition, if the principal business of the partnership is trading stock or securities for its own account, the safe harbor generally does not apply if the principal office of the partnership is 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 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)(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 stock and securities trading safe harbor serves to promote foreign investment in U.S. capital markets. The Committee understands that the principal office rule operates simply to shift certain administrative functions with respect to securities trading—and the associated jobs—offshore. The Committee believes that the elimination of this rule would facilitate the foreign investment in U.S. markets that the safe harbor was designed to promote.

Explanation of Provision

The bill modifies the stock and securities trading safe harbor by eliminating the requirement for both partnerships and foreign corporations that trade stock or securities for their own account 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.

G. OTHER FOREIGN PROVISIONS

1. Inclusion of income from notional principal contracts and stock lending transactions under subpart F (sec. 1171 of the bill and sec. 954 of the Code)

Present 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 consists 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 is treated as foreign personal holding company income; income from equity swaps or other types of notional principal contracts is not treated as foreign personal holding company income. Income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally is excluded from the definition of foreign personal holding company income. However, no exception is 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 Committee understands that income from notional principal contracts and stock-lending transactions is economically equivalent to types of income that are treated as foreign personal holding company income under present law. Accordingly, the Committee believes that the categories of foreign personal holding company income should be expanded to cover such income. In addition, the Committee believes 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 bill 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.

The bill 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 bill 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.

2. Restrict like-kind exchange rules for certain personal property (sec. 1172 of the bill and sec. 1031 of the Code)

Present 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 both 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 taxpayer, 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 Committee believes that the depreciation rules applicable to foreign- and domestic-use are sufficiently dissimilar so as to treat such property as not "like-kind" property for purposes of section 1031.

Explanation of Provision

The bill 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 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 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.

3. Impose holding period requirement for claiming foreign tax credits with respect to dividends (sec. 1173 of the bill and new sec. 901(k) of the Code)

Present 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, regardless of 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, also without regard to the U.S. shareholder's holding period for the corporation's stock (sections 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 present law imposes a holding period requirement for the dividends-received deduction for a corporate shareholder (sec. 246), there is no similar holding period requirement for foreign tax credits with respect to dividends. As a result, some U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits is prevented by the limitation) to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits.

Explanation of Provision

The bill 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 bill, the minimum holding period for dividends on common stock is 16 days. The minimum holding period for preferred stock is 46 days.

Where the holding period requirement is not met for stock of a foreign corporation, the bill disallows the foreign tax credits for the foreign withholding taxes that are paid with respect to a dividend. Such credits are denied both to the shareholder and any other taxpayer who would otherwise be entitled to claim foreign tax credits for such withholding taxes (secs. 853, 902 and 960). In addition, the bill applies to all foreign tax credits otherwise allowable for taxes paid by a lower-tier foreign corporation (secs. 902 and 960) and for foreign taxes credits of a RIC that elects to treat its foreign taxes as paid by the shareholders (section 853). The bill 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 bill denies these same foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the taxpayer 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- or 46-day holding period under the bill (whichever applies) must be satisfied over a period immediately before or immediately after the shareholder becomes entitled to receive each dividend. For purposes of determining whether the required holding period is met, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) would not be included. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after 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 bill, 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 the single day during which the loss on the stock was not protected. The bill provides a special rule that treats a bona fide contract to sell stock as not protecting a stockholder from risk of loss for purposes of the holding period requirement.

The bill 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 a foreign country, and (3) the foreign taxes to which the exception applies must be taxes that are creditable under the foreign country's tax system. A securities dealer for purposes of the exception must be an entity which (1) regularly enters into stock or securities transactions with customers (section 475(c)(1)) and (2) is registered as a securities dealer under the Securities Exchange Act of 1934 or is licenced or authorized to sell stock to or from customers and subject to bona fide regulation by the securities regulatory authority of the foreign country in which the relevant dividend is subject to net-basis taxation. Under the bill, the Treasury is granted authority to issue regulations necessary or appropriate to prevent abuse of this exception. It is expected that such regulations will provide guidance as to the determination of whether stock is held in a taxpayer's capacity as a dealer or in connection with its securities trading activities.

If a taxpayer is denied foreign tax credits under the bill 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 present law of tax-motivated transactions intended to transfer foreign tax credit benefits.

Effective Date

The provision would be effective for dividends paid or accrued more than 30 days after the date of enactment.

4. Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons (sec. 1174 of the bill and sec. 872 and 883 of the Code)

Present Law

The United States generally imposes a 4-percent tax on the U.S.-source gross transportation income of foreign persons that is not effectively connected with the foreign person's conduct of a U.S. trade or business (sec. 887). Foreign persons generally are subject to U.S. tax at regular graduated rates on net income, including transportation income, that is effectively connected with a U.S. trade or business (secs. 871(b) and 882).

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use (sec. 863(c)(3)). Income attributable to transportation that begins and ends in the United States is treated as derived from sources in the United States (sec. 863(c)(1)). In the case of transportation that either begins or ends in the United States, generally 50 percent of such income is treated as U.S. source and 50 percent is treated as foreign source (sec. 863(c)(2)). U.S.-source transportation income is treated as effectively connected with a foreign person's conduct of U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation (sec. 887(b)(4)).

An exemption from U.S. tax is provided for income derived by a nonresident alien individual or foreign corporation from the international operation of a ship or aircraft, provided that the foreign country in which such individual is resident or such corporation is organized grants an equivalent exemption to individual residents of the United States or corporations organized in the United States (secs. 872(b) (1) and (2) and 883(a) (1) and (2)).

Pursuant to guidance published by the Internal Revenue Service, a nonresident alien individual or foreign corporation that is entitled to an exemption from U.S. tax for its income from the international operation of ships or aircraft must file a U.S. income tax return and must attach to such return a statement claiming the exemption (Rev. Proc. 91–12, 1991–1 C.B. 473). If the foreign person is claiming an exemption based on an applicable income tax treaty, the foreign person must disclose that fact as required by the Secretary of the Treasury (sec. 6114). The penalty for failure to make disclosure of a treaty-based position as required under section 6114 is $1,000 for an individual and $10,000 for a corporation (sec. 6712).

At the time the 4-percent tax on U.S.-source gross transportation income was enacted, concern was expressed about whether compliance with the tax, which is collected by return, would be adequate. It was intended that the tax-writing committees of Congress and the Secretary of the Treasury would study the issue of compliance and that the Secretary would make recommendations if compliance did not prove adequate. Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986" (JCS–10–87), May 4, 1987, at 930.

Reasons for Change

The Committee understands that there is an extremely high level of noncompliance by foreign persons that have U.S.-source shipping income. The Committee believes that, in order to address these noncompliance problems, it is appropriate to impose significant penalties for a failure to satisfy the filing requirements for claiming the exemption from U.S. tax that is available to certain foreign persons with respect to income from the international operation of ships or aircraft.

Explanation of Provision

Under the bill, a foreign person that claims exemption from U.S. tax for income from the international operation of ships or aircraft, but does not satisfy the filing requirements for claiming such exemption, is subject to the penalty of the denial of such exemption and any deductions or credits otherwise allowable in determining the U.S. tax liability with respect to such income. If a foreign person that has a fixed place of business in the United States fails to satisfy the filing requirements for claiming an exemption from U.S. tax for its income from the international operation of ships or aircraft, such person is subject to the additional penalty that foreign source income from the international operation of ships or aircraft would be treated as effectively connected with the conduct of a U.S. trade or business, but only to the extent that such income is attributable to such fixed place of business in the United States. Income so treated as effectively connected with a U.S. business is subject to U.S. tax at graduated rates (and is subject to the disallowance of deductions and credits described above). These penalties do not apply in the case of a failure to disclose that is due to reasonable cause. The provision would not apply to the extent the application would be contrary to any treaty obligation of the United States.

The bill also provides for the provision of information by the U.S. Customs Service to the Secretary of the Treasury regarding foreign-flag ships engaged in shipping to or from the United States.

Effective Date

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

5. Limitation on treaty benefits for payments to hybrid entities (sec. 1175 of the bill)

Present 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 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 may 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). Regulations that have been proposed but not yet finalized would address this issue in the case of an item received by a foreign entity by allowing an interest holder in that entity to claim a reduced rate of withholding tax with respect to that item under a treaty only if the treaty partner requires the interest holder to include in income its distributive share of the entity's income on a flow-through basis. Prop. Treas. Reg. Sec. 1.1441–6(b)(4). This provision in the proposed regulations does not apply in the case of a U.S. entity.

Reasons for Change

The Committee is concerned about the potential tax-avoidance opportunities available for foreign persons that invest in the United States through hybrid entities. In particular, the Committee understands that the interaction of the tax laws and the applicable tax treaty may 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 Committee believes that such tax-avoidance opportunities should be eliminated.

Explanation of Provision

The bill limits the availability of a reduced rate of withholding tax pursuant to an income tax treaty in order to prevent tax avoidance. Under the bill, a foreign person is 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 a partnership (or is otherwise treated as transparent) for U.S. tax purposes only if such item is treated for purposes of the taxation laws of such foreign country as an item of income of such person. This rule does not apply if the treaty itself contains a provision addressing the applicability of the treaty in the case of income derived through a partnership. Moreover, the rule does not apply if the foreign country imposes tax on an actual distribution of such item of income from such partnership to such person. 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.

This bill addresses a potential tax-avoidance opportunity for Canadian corporations with U.S. subsidiaries that arises 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 may be 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 bill, withholding tax is imposed at the full statutory rate of 30 percent in such case. The bill would not apply if the U.S.-Canadian income tax treaty is amended to include a provision reaching a similar result. In this regard, the United States and Canada recently negotiated a proposed protocol that would amend the provision in the treaty governing cross-border social security payments and this issue could be addressed in the context of that protocol or an additional protocol. Moreover, the bill would not apply if Canada were to impose tax on the Canadian parent on dividends received from the U.S. limited liability company.

The Committee believes that the provision generally is consistent with U.S. treaty obligations, including the U.S.-Canada treaty. The United States has recognized authority to implement its tax treaties so as to avoid abuses.

Effective Date

The provision is effective upon date of enactment.

6. Interest on underpayment reduced by foreign tax credit carryback (sec. 1176 of the bill and secs. 6601 and 6611 of the Code)

Present 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 *Fluor Corp.* v. *United States,* 35 Fed. Cl. 520 (1996), the court held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that is eliminated by a foreign tax credit carryback from a subsequent taxable year, interest does not accrue on the underpayment that is eliminated by the foreign tax credit carryback. The Government has filed an appeal in the *Fluor* case.

Reasons for Change

The Committee believes 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 Committee believes 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 Committee believes 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 bill, 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 bill 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 present 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 date of enactment.

7. Determination of period of limitations relating to foreign tax credits (sec. 1177 of the bill and sec. 6511(d) of the Code)

Present 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 (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 Committee believes 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 bill, 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 present law.

Effective Date

The provision is effective for foreign taxes paid or accrued in taxable years beginning after date of enactment.

8. Clarification of determination of foreign taxes deemed paid (sec. 1178(a) of the bill and sec. 902 of the Code)

Present 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 Committee believes that it is appropriate to clarify the determination of foreign taxes deemed paid for purposes of the indirect foreign tax credit.

Explanation of Provision

The bill 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 present law.

Effective Date

The provision is effective on date of enactment.

9. Clarification of foreign tax credit limitation for financial services income (sec. 1178(b) of the bill 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 Committee believes that it is 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 bill 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 present law.

Effective Date

The provision is effective on date of enactment.

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 bill and secs. 59(j) and 63(c)(5) of the Code)

Present Law

Standard deduction of dependents.—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)[1] or the dependent's earned income (sec. 63(c)(5)).

[1] The indexed amount is projected to be $700 for 1998.

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[2] (indexed) plus (2) the greater of (a) $500[3] (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 sum of earned income and $1,400 (sec. 59(j)).

Reasons for Change

The Committee believes that significant simplification of the existing income tax system can 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 Committee particularly believes that the present-law exemptions of dependent children are too small.

Explanation of Provision

Standard deduction of dependents.—The bill 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[4] (indexed for inflation as under present law), or (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 bill 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.

[2] Projected to be $700 for 1998.

[3] Projected to be $700 for 1998.

[4] Projected to be $700 for 1998.

2. Increase de minimis threshold for estimated tax to $1,000 for individuals (sec. 1202 of the bill and sec. 6654 of the Code)

Present 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. 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 and estimated tax payments, is less than $500.

Reasons for Change

Raising the individual estimated tax de minimis threshold will simplify the tax laws for a number of taxpayers.

Explanation of Provision

The bill 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.

3. Optional methods for computing SECA tax combined (sec. 1203 of the bill and sec. 1402 of the Code)

Present Law

The Self-Employment Contributions Act ("SECA") imposes taxes on net earnings from self-employment to provide social security coverage to self-employed workers. The maximum amount of earnings subject to the SECA tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes ($65,000 for OASDI taxes in 1997 and indexed annually, and without limit for the Hospital Insurance tax). Special rules allow certain self-employed individuals to continue to maintain social security coverage during a period of low income. The method applicable to farmers is slightly more favorable than the method applicable to other self-employed persons.

A farmer may increase his or her self-employment income, for purposes of obtaining social security coverage, by reporting two-thirds of the first $2,400 of gross income as net earnings from self-employment, i.e., the optional amount of net earnings from self-employment would not exceed $1,600. There is no limit on the number of times a farmer may use this method. The optional method for non farm income is similar, also permitting two-thirds of the first $2,400 of gross income to be treated as self-employment income. However, the optional non farm method may not be used more than five times by any individual, and may only be used if the taxpayer had net earnings from self-employment of $400 or more in at least two of the three years immediately preceding the year in which the optional method is elected.

In general, to receive benefits, including Disability Insurance Benefits, under the Social Security Act, a worker must have a minimum number of quarters of coverage. A minimum amount of wages or self-employment income must be reported to obtain a quarter of coverage. A maximum of four quarters of coverage may be obtained each year. In 1978, the amount of earnings required to obtain a quarter of coverage began increasing each year. Starting in 1994, a farmer could obtain only two quarters of coverage under the optional method applicable to farmers.

Reasons for Change

The Committee believes that providing different optional methods for farm and non farm income is unduly complex and unwarranted. In addition, current law is misleading in that a worker may qualify for the optional method but not be eligible for a full four quarters of Social Security coverage. A single optional method benefits self-employed workers by simplifying the rules for obtaining Social Security coverage.

Explanation of Provision

The bill combines the farm and non farm optional methods into a single combined optional method applicable to all self-employed workers. A self-employed worker may elect to use the optional method an unlimited number of times. If it is used, it must be applied to all self-employment earnings for the year, both farm and non farm.

The $2,400 amount is increased to an amount which would provide four quarters of coverage in 1998 (the "lower limit"). Such amount increases each year based on the earnings requirements under the Social Security Act.

The optional method in this provision is elected on a year-by-year basis. An election for a taxable year must be filed with the original Federal income tax return for the year, and may not be made retroactively by filing an amended return.

Effective Date

The provision is effective for taxable years beginning after January 1, 1998.

4. Treatment of certain reimbursed expenses of rural letter carriers' vehicles (sec. 1204 of the bill and sec. 162 of the Code)

Present 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 present 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 bill repeals the special rate for Postal Service employees of 150 percent of the standard mileage rate. In its place, the bill 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.

5. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 1205 of the bill and sec. 162 of the Code)

Present 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 Committee believes 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).

Effective Date

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment.

6. Payment of taxes by commercially acceptable means (sec. 1206 of the bill and sec. 6311 of the Code)

Present 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 bill allows the IRS to accept payment by any commercially acceptable means that the Secretary deems appropriate, to the extent and under the conditions provided 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 bill provides that the Federal Government may pay fees with respect to any such contracts only out of amounts specifically appropriated for that purpose.

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 bill 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 bill 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 bill 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 account. 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 bill 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 bill 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 bill 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.

B. PROVISIONS RELATING TO BUSINESSES GENERALLY

1. Modifications to look-back method for long-term contracts (sec. 1211 of the bill and secs. 460 and 167(g) of the Code)

Present 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 Internal Revenue Service) 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.[5] 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 and 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.

Reasons for Change

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though amounts necessitating the look-back calculations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back calculation. The Committee wishes to address these concerns.

Explanation of Provision

Election not to apply the look-back method for de minimis amounts

The provision 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.

[5] 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.

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, respectively, for Years 1, 2, and 3 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 provision provides that a taxpayer may elect not to 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 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, respectively, for Years 1 through 3 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 reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract 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 contract 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 contract 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 provision 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. 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.

2. Minimum tax treatment of certain property and casualty insurance companies (sec. 1212 of the bill and sec. 56(g)(4)(B) of the Code)

Present Law

Present law provides 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.

Under present law, 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 Committee believes 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 present law, the simplicity under the regular tax is nullified because electing companies must 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 bill 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.

C. PARTNERSHIP SIMPLIFICATION PROVISIONS

1. General provisions

a. Simplified flow-through for electing large partnerships (sec. 1221 of the bill and new secs. 771–777 of the Code)

Present 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

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. 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 electing 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 include rental activities (regardless of the taxpayer's material participation).[6] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

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 partner-

[6] An individual who actively participates in a 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.

ship 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 five years of its contribution (sec. 704(c)), or if other property is distributed to the contributor within the five 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 bill 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.[7] Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items.

Under the bill, 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.[8] 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 bill, 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 cap-

[7] 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.

[8] 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.

ital gain or net capital loss.[9] Such net capital gain or loss is treated as long-term capital gain or loss.

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 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 bill 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; [10] 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 bill. 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 bill, 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 present law 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.[11] In addition, the credit for producing fuel from a nonconventional source is separately reported.

[9] 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.

[10] 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.

[11] 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 part-

Continued

The bill 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 bill, the transfer of an interest in an electing large partnership does not trigger recapture.

Foreign taxes

The bill retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the 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 bill 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 bill 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 bill, a partner in an electing large partnership takes in an electing to 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

nership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

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 bill, 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 bill, 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 bill, 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. As under present law, 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, as under present law.

Terminations

The bill 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 taxable 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 bill 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 bill 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 bill.

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 bill 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 bill, however, apply with respect to reporting such a partner's share of items not related to oil and gas activities.

The bill 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 bill, 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 bill 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 bill without applying the 65-percent-of-taxable-income limitation under section 613A(d)(1).

As under present law, an election to deduct IDCs under section 263(c) is made at the partnership level. Since the bill 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 present 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 bill.

Consistent with the general reporting regime for electing large partnerships, the bill 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 computing this limitation, the bill 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 bill 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 provisions generally apply to partnership taxable years beginning after December 31, 1997.

b. Simplified audit procedures for electing large partnerships (sec. 1222 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6255, and 6256 of the Code)

Present 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

Present 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 bill 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 present 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 present law.

Unlike present 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 non-deductible.

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 present 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 present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill 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 present 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 present 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.

c. Due date for furnishing information to partners of electing large partnerships (sec. 1223 of the bill and sec. 6031(b) of the Code)

Present 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 bill 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.

d. Partnership returns required on magnetic media (sec. 1224 of the bill and sec. 6011 of the Code)

Present 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 integration of partnership information into already existing data systems.

Explanation of Provision

The bill 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.

e. Treatment of partnership items of individual retirement arrangements (sec. 1225 of the bill and sec. 6012 of the Code)

Present 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 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 present law, tax returns often must be filed for IRAs that have 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 bill 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.

2. Other partnership audit rules

a. Treatment of partnership items in deficiency proceedings (sec. 1231 of the bill and sec. 6234 of the Code)

Present Law

Partnership proceedings under rules enacted in TEFRA[12] 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

[12] Tax Equity and Fiscal Responsibility Act of 1982.

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 would be no deficiency since, under *Munro,* the income must be ignored.

Explanation of Provision

The bill 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 bill 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 bill 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 bill 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 is 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 bill and sec. 6231 of the Code)

Present 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 bill 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 bill and sec. 6229 of the Code)

Present 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 present law, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is 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 bill 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.

ii. Suspend statute of limitations during bankruptcy proceedings (sec. 1233(b) of the bill and sec. 6229 of the Code)

Present 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.

Under present law, 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 present law makes 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 result 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 bill 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 present 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.

iii. Extend statute of limitations for bankrupt TMPs (sec. 1233(c) of the bill and sec. 6229 of the Code)

Present 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(l)(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 bill 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 present law.

Effective Date

The provision is effective for extension agreements entered into after the date of enactment.

d. Expansion of small partnership exception (sec. 1234 of the bill and sec. 6231 of the Code)

Present 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 mere 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 bill 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 of present law 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.

e. Exclusion of partial settlements from 1-year limitation on assessment (sec. 1235 of the bill and sec. 6229(f) of the Code)

Present 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 bill 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 present law.

Effective Date

The provision is effective for settlements entered into after the date of enactment.

f. Extension of time for filing a request for administrative adjustment (sec. 1236 of the bill and sec. 6227 of the Code)

Present 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 bill 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 bill and sec. 6230 of the Code)

Present 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 bill 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 bill 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 bill and sec. 6221 of the Code)

Present 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 bill 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.

i. Provisions relating to Tax Court jurisdiction (sec. 1239 of the bill and secs. 6225 and 6226 of the Code)

Present 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." Present 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 bill 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.

j. Treatment of premature petitions filed by notice partners or 5-percent groups (sec. 1240 of the bill and sec. 6226 of the Code)

Present 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 permitted 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 bill 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 is not available under present law.

Effective Date

The provision is effective with respect to petitions filed after the date of enactment.

k. Bonds in case of appeals from certain proceedings (sec. 1241 of the bill and sec. 7485 of the Code)

Present 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 bill 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 bill and sec. 6601 of the Code)

Present 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 bill 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.

m. Special rules for administrative adjustment requests with respect to bad debts or worthless securities (sec. 1243 of the bill and sec. 6227 of the Code)

Present 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 bill 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.

3. Closing of partnership taxable year with respect to deceased partner (sec. 1246 of the bill and sec. 706(c)(2)(A) of the Code)

Present 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.

Present law closes 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 bill 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 bill does not change present 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.

D. MODIFICATIONS OF RULES FOR REAL ESTATE INVESTMENT TRUSTS (SECS. 1251–1263 OF THE BILL AND SECS. 856 AND 857 OF THE CODE)

Present 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, 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 their holding period of the 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)). 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, substantially 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. 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.

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, 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

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and 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 collection 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)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REIT's ownership interest in a tenant, 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)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, 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, 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)).

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 (described below).

Excess noncash items include (a) 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.

Reasons for Change

The REIT serves as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management. The Committee believes that the asset requirements of present law ensure that a REIT acts as a pass-through entity for taxpayers wishing to invest in real estate. Therefore, the Committee finds the 30-percent gross income test unnecessary and administratively burdensome. The Committee further finds that financial markets have changed over the past decade such that interest risk can be managed by many strategies other than swaps and caps. Recognizing these developments in the financial markets, the Committee believes it necessary to modify the classification of income from certain hedging instruments to provide flexibility to REITs in managing risk for their shareholders. The Committee also believes that, as a pass-through entity, REITs should be permitted to retain the proceeds of realized capital gains in a manner comparable to that accorded to RICs.

Explanation of Provisions

Overview

The bill 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.

Clarification of limitation on maximum number of shareholders (sec. 1251 of the bill and secs. 856(k), 857(a), and 857(f) of the Code)

The bill 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 would be $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 bill and sec. 856(d) of the Code)

The bill 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 bill and sec, 856(d)(5) of the Code)

The bill modifies the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution occurs only when a partner owns a 25 percent or greater interest in the partnership.

Credit for tax paid by REIT on retained capital gains (sec. 1254 of the bill and sec. 857(b)(3) of the Code)

The bill 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 bill and sec. 856(c) of the Code

The bill 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 bill and sec. 857(d) of the Code

The bill 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 bill, 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 bill and sec. 856(e) of the Code

The bill 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 could be extended for an additional three years by filing a request to the IRS. Under the bill, a REIT could 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 bill 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 bill and sec. 856(c)(5)(G) of the Code

The bill 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 bill and sec. 857(e)(2) of the Code

The bill (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 bill and sec. 856(b)(6)(C) of the Code)

The bill excludes from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages (sec. 1261 of the bill and sec. 856(j) of the Code)

The bill 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 4 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 bill and sec. 856(I)(2)of the Code)

The bill 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, the bill treats any such corporation 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 section 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 bill is effective for taxable years beginning after the date of enactment.

E. REPEAL OF THE SHORT-SHORT TEST FOR REGULATED INVESTMENT COMPANIES (SEC. 1271 OF THE BILL AND SEC. 851(B)(3) OF THE CODE)

Present Law

To qualify as a Regulated Investment Company (RIC), a company must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the “30-percent test” or “short-short rule”).

Reasons for Change

The short-short rule restricts the investment flexibility of RICs. The rule can, for example, limit a RIC’s ability to “hedge” its investments (e.g., to use options to protect against adverse market moves).

The rule 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 Committee believes that the short-short test places unnecessary limitations upon a RIC’s activities.

Explanation of Provision

The 30-percent test (or short-short rule) is repealed.

Effective Date

The provision is effective for taxable years ending after the date of enactment.

F. TAXPAYER PROTECTIONS

1. Provide reasonable cause exception for additional penalties (sec. 1281 of the bill and secs. 6652, 6683, 7519 of the Code)

Present 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 Committee believes that it is appropriate to provide a reasonable cause exception for several additional penalties where one does not currently exist.

Explanation of Provision

The bill 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 is effective for taxable years beginning after the date of enactment.

2. Clarification of period for filing claims for refunds (sec. 1282 of the bill and sec. 6512 of the Code)

Present 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 overwithheld 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 overwithheld amounts.

Reasons for Change

The Committee believes that it is appropriate to eliminate this disparate treatment.

Explanation of Provision

The bill 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 tax years ending after the date of enactment.

3. Repeal of authority to disclose whether a prospective juror has been audited (sec. 1283 of the bill and sec. 6103 of the Code)

Present 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 bill 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 is effective for judicial proceedings commenced after the date of enactment.

4. Clarify statute of limitations for items from pass-through entities (sec. 1284 of the bill and sec. 6501 of the Code)

Present Law

Pass through 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 bill 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 is effective for taxable years beginning after the date of enactment.

5. Awarding of administrative costs and attorneys fees (sec. 1285 of the bill and sec. 7430 of the Code)

Present 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 bill 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 bill 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 bill 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 is effective with respect to costs incurred in civil actions or proceedings commenced after the date of enactment.

6. Prohibition on browsing (secs. 1286 and 1287 of the bill and secs. 7213A and 7431 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 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").[13] 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.[14] 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.[15] This provision does not apply to unauthorized inspection of paper documents.

Reasons for Change

The Committee believes that it is important to have a criminal penalty in the Internal Revenue Code to punish this type of behavior. The Committee also believes that it is appropriate to provide for civil damages for unauthorized inspection parallel to civil damages for unauthorized disclosure.

[13] IRS Declaration of Privacy Principles, May 9, 1994.

[14] *U.S.* v. *Czubinski,* DTR 2/25/97, P. K–2.

[15] P.L. 104–294, sec. 201 (October 11, 1996).

Explanation of Provisions

Criminal penalties

The bill 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 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,[16] 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 views any unauthorized inspection of tax returns or return information as a very serious offense; this new criminal penalty reflects that view. The Congress also believes 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

The bill 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 bill also provides that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The bill 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), section 7213A (as added by the bill), 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 bill is effective for violations occurring on or after the date of enactment.

[16] 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.

Title XIII. Estate, Gift, and Trust Tax Simplification

1. Eliminate gift tax filing requirements for gifts to charities (sec. 1301 of the bill and sec. 6019 of the Code)

Present 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). This filing requirement applies to all gifts, whether charitable or noncharitable, and whether or not the gift qualifies for a gift tax charitable deduction. Thus, under current law, a gift tax return is required to be filed for gifts to charity in excess of $10,000, even though no gift tax is payable on the transfer.

Reasons for Change

Because a charitable gift does not give rise to a gift tax liability, many donors are 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 expose the donor to penalties. The bill eliminates this potential trap for the unwary.

Explanation of Provision

The bill provides that gifts to charity are not subject to the gift tax filing requirements of section 6019, as long as the entire value of the transferred property 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.

2. Clarification of waiver of certain rights of recovery (sec. 1302 of the bill and secs. 2207A and 2207B of the Code)

Present 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). For this purpose, a will provision specifying that all taxes shall be paid by the estate is 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). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Change

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Similarly, persons waiving a right to contribution are unlikely to refer to the code section granting the right. Accordingly, allowing the right of recovery (or right of contribution) to be waived only by specific reference should simplify the drafting of wills by better conforming with the testator's likely intent.

Explanation of Provision

The bill 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 bill 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.

3. Transitional rule under section 2056A (sec. 1303 of the bill and sec. 2056A of the Code)

Present 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 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

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.

4. Clarifications relating to disclaimers (sec. 1304 of the bill and sec. 2518 of the Code)

Present Law

Historically, there must be acceptance of a gift in order for the gift to be completed under State law and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules that provide that, where there is a disclaimer of a gift, the property passes to the person who is entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress provided a uniform disclaimer rule (section 2518) that specified how and when a disclaimer under State law must be made in order to be effective for Federal transfer tax purposes. Under section 2518, a State law type disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied. One of these other requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs. Section 2518 is not presently effective for Federal tax purposes other than transfer taxes.

In 1981, Congress added a rule to section 2518 that allowed certain transfers of property to be treated as a qualified disclaimer. In order to qualify, these transfer-type disclaimers must be a written transfer of the disclaimant's "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law (sec. 2518(c)(3)). Like other disclaimers, the transfer-type disclaimer generally must be made within nine months of the transfer creating the interest.

Reasons for Change

Under present law, a State law type disclaimer can be a qualified disclaimer even (1) where it is only a partial disclaimer of the property interest, or (2) where the disclaimant spouse retains an interest in the property. In contrast, it is presently unclear whether a transfer-type disclaimer can qualify under similar circumstances. Thus, in order to equalize the treatment of State law type disclaimers and transfer-type disclaimers, the Committee believes it is appropriate to allow a transfer-type disclaimer of an undivided portion of property or a transfer-type disclaimer where the disclaimant spouse has retained an interest in the property to be treated as a qualified disclaimer for transfer tax purposes.

The Committee also believes that qualified disclaimers should be effective for Federal income tax purposes, as well as transfer tax purposes.

Explanation of Provision

The bill allows a transfer-type disclaimer of an "undivided portion" of the disclaimant transferor's interest in property to qualify under section 2518. Also, the bill allows a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the disclaimant spouse has an interest (e.g., a credit shelter trust). Finally, the bill provides that a qualified disclaimer for transfer tax purposes under section 2518 is also effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent).

None of the foregoing provisions are intended to create an inference regarding the Federal tax treatment of disclaimers under present law.

Effective Date

The provision applies to disclaimers made after the date of enactment.

5. Amend "5 or 5 power" (sec. 1305 of the bill and secs. 2041(b)(2) and 2514(e) of the Code)

Present Law

The exercise or release of a general power of appointment generally is considered a gift by the person holding the power (sec. 2514(b)). A special rule, however, provides that the lapse of a power of appointment during the life of the person holding the power is considered a release (and thus a taxable gift) only to the extent that the value of the property over which the power lapsed exceeds the greater of $5,000 or five percent of the value of the assets of the trust (sec. 2514(e)). A similar provision applies for purposes of estate taxation (sec. 2041(b)(2)).

Reasons for Change

Because the present-law limitation equals the greater of $5,000 or five percent of the value of the assets of the trust, the $5,000 limitation has the practical effect of being binding only on those trusts with assets of $200,000 or less. The Committee understands that the limitation often is avoided through a series of complicated drafting techniques. Raising the limitation to $10,000 will ease the burden on these smaller trusts by eliminating the need to engage in such complicated drafting techniques.

Explanation of Provision

The bill increases the limitations in sections 2514(e) and 2041(b)(2) to the greater of $10,000 or 5 percent.

Effective Date

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

6. Treatment for estate tax purposes of short-term obligations held by nonresident aliens (sec. 1306 of the bill and sec. 2105 of the Code)

Present 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. However, because of an amendment to section 871(h) made by the Tax Reform Act of 1986, these special rules no longer cover obligations that generate short-term OID income despite the fact that such income is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(I)).

Reasons for Change

The Committee believes 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 is 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 be a trap for the unwary.

Explanation of Provision

The bill 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 present law.

Effective Date

The provision is effective for estates of decedents dying after the date of enactment.

7. Certain revocable trusts treated as part of estate (sec. 1307 of the bill and secs. 646 and 2652(b)(1) of the Code)

Present 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 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 can qualify for section 194 amortization of reforestation expenditures, while trusts do not.

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 discourage 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 Committee believes it is 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 bill 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 from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or, if later, 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).

As described below, the separate share rule may 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.

8. Distributions during first 65 days of taxable year of estate (sec. 1308 of the bill and sec. 663(b) of the Code)

Present 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. The 65-day rule is not applicable to estates.

Reasons for Change

In order to minimize the tax differences between estates and revocable trusts, the Committee believes that the 65-day rule should be allowed to estates as well as to trusts.

Explanation of Provision

The bill extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid 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.

9. Separate share rules available to estates (sec. 1309 of the bill and sec. 663(c) of the Code)

Present 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.[17] 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). The separate share rule presently does not apply to estates.

Reasons for Change

The Committee understands 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 Committee believes 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 bill 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) cre-

[17] Application for the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

ates 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 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.

10. Executor of estate and beneficiaries treated as related persons for disallowance of losses (sec. 1310 of the bill and secs. 267(b) and 1239(b) of the Code)

Present 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.

Neither section 267 or section 1239 presently treat an estate and a beneficiary of the estate as related persons.

Reasons for Change

The Committee believes 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 bill, 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.

11. Limitation on taxable year of estates (sec. 1311 of the bill and sec. 645 of the Code)

Present Law

The taxability of distributions from a trust or estate is based on the amount of income received by the trust or estate in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary (typically a calendar year). Trusts are required to use a calendar year and, consequently, income of a trust that is distributed to a calendar-year beneficiary in the year earned is taxed to the beneficiary in the year earned. Estates, on the other hand, are allowed to use any fiscal year. Consequently, in the case of estates, the taxation of distributions to a calendar-year beneficiary in up to the last 11 months of the calendar year can be deferred until the next taxable year depending upon the fiscal year selected.

Reasons for Change

The Committee believes that allowing an estate to use a taxable year significantly different than the calendar year may result in an improper deferral of income by the beneficiaries of the estate. Thus, the Committee believes that the choice of taxable years allowable to an estate should be appropriately limited.

Explanation of Provision

The bill limits the taxable year of an estate to a year ending on October 31, November 30, or December 31.[18] Thus, the maximum deferral allowable to a calendar-year beneficiary is with respect to distributions made in the last two months of the calendar year.

Effective Date

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

12. Simplified taxation of earnings of pre-need funeral trusts (sec. 1312 of the bill and sec. 684 of the Code)

Present Law

A pre-need funeral trust is an arrangement where an individual purchases funeral services or merchandise from a funeral home in advance of the individual's death. The individual enters into a contract with the provider of such services or merchandise whereby the individual selects the services or merchandise to be provided upon his or her death, and agrees to pay for them in advance of

[18] If an election is made to treat a revocable trust as part of the estate under section 14601 of the bill, such trust would switch to the taxable year of the estate during the period that the election was effective.

his or her death. Such amounts (or a portion thereof) are held in trust during the individual's lifetime and are paid to the seller upon the individual's death.

Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is 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 are treated as grantor trusts under present law, numerous individual taxpayers are required to account for the earnings of such trusts on their tax returns, even though the earnings with respect to any one taxpayer may be small. The Committee believes 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 bill 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 between a person engaged in the trade or business of providing funeral or burial services or merchandise and one or more individuals to have such services or property provided upon such individuals' death; (2) the only beneficiaries of the trust are individuals who have entered into contracts to have such services or merchandise provided upon their death; (3) the only contributions to the trust are contributions 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 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 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 present 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 beneficiary of the trust for payments from the trust to the beneficiary upon cancellation of the contract, and the beneficiary takes a carryover basis in any assets received from the trust upon cancellation.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

13. Adjustments for gifts within three years of decedent's death (sec. 1313 of the bill and secs. 2035 and 2038 of the Code)

Present 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 Committee believes that inclusion of such amounts is unnecessary where the transferor has retained no power over the property transferred out of the trust. The Committee believes that clarifying these rules statutorily will lend certainty to these rules.

Explanation of Provision

The provision 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 also revises section 2035 to improve its clarity.

Effective Date

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

14. Clarify relationship between community property rights and retirement benefits (sec. 1314 of the bill and sec. 2056(b)(7)(C) of the Code)

Present 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 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 Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

Reasons for Change

The Committee believes 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 bill would clarify 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 bill 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 bill, 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 present law of a transfer to a surviving spouse of the decedent spouse's interest in an annuity arising under community property laws.

Effective Date

The provision applies to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.

15. Treatment under qualified domestic trust rules of forms of ownership which are not trusts (sec. 1315 of the bill and sec. 2056A(c) of the Code)

Present 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).[19] As a result, it is not possible 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 Committee believes it is 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.

[19] Note that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct, exists.

Explanation of Provision

The bill 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.

Effective Date

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

16. Opportunity to correct certain failures under section 2032A (sec. 1316 of the bill and sec. 2032A of the Code)

Present 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 is to disallow current use valuation elections unless the required information is supplied.

Reasons for Change

It is 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. It is believed that allowing such signatures or information to be supplied later is consistent with the legislative intent of section 2032A and eases return filing.

Explanation of Provision

The bill 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 bill 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 bill also allows the addition of signatures to a previously filed agreement.

The Committee believes that the Treasury Department has taken an unnecessarily restrictive view of the 1984 amendment to section 2032A and intends no inference that the Treasury Department lacks the power, under the law in effect prior to the date of enactment, to correct the situation addressed by this provision. The Committee intends that, with respect to technically defective 2032A elections made prior to the date of enactment, prior law should be applied in a manner consistent with the provision.

Effective Date

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

17. Authority to waive requirement of U.S. trustee for qualified domestic trusts (sec. 1317 of the bill and sec. 2056A(a)(1)(A) of the Code)

Present Law

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 cannot qualify as a QDT.

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 Committee believes it is 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 bill 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. For example, one possible mechanism would be 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.

Effective Date

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

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 bill and sec. 4001 and 4051 of the Code)

Present 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 scheduled to be 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 are generally 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. Parts and accessories installed on a vehicle on or before that date are taken into account in determining whether the $1,000 threshold is exceeded. If the aggregate price of the pre-effective date parts and accessories does not exceed $200, they will not be subject to tax unless the aggregate price of all additions exceeds $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 on January 1, 1998.

2. Modify treatment of tires under the heavy highway vehicle retail excise tax (sec. 1402 of the bill and sec. 4071 of the Code)

Present 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 is excluded from the 12-percent excise tax on heavy highway vehicles. The determination of value is factual and has given rise to numerous tax audit challenges.

Reasons for Change

Allowing a credit for the tire tax actually paid on truck tires will simplify the application of the retail truck tax.

Explanation of Provision

The current 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 after December 31, 1997.

3. Simplification of excise taxes on distilled spirits, wine, and beer (secs. 1411–1422 of the bill and secs. 5008, 5044, 5053, 5055, 5115, 5175, and 5207, and new secs. 5222 and 5418 of the Code)

Present 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. Tax is 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. The required bonds are 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 are 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 may receive on its bonded premises beer to be used in the production of distilled spirits only if the beer is produced on contiguous brewery premises.

Sign not required for wholesale dealers.—Wholesale liquor dealers are required to post a sign identifying the firm as such. Failure to do so is subject to a penalty.

Refund on returns of merchantable wine.—Excise tax paid on domestic wine that is returned to bond as unmerchantable is refunded or credited, and the wine is once again treated as wine in bond on the premises of a bonded wine cellar.

Increased sugar limits for certain wine.—Natural wines may be sweetened to correct high acid content. For most wines, however, sugar cannot constitute more than 35 percent (by volume) of the combined sugar and juice used to produce the wine. Up to 60 percent sugar may be used in wine made from loganberries, currants, and gooseberries. If the amount of sugar used exceeds the applicable limitation, the wine must 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. No similar exemption applies 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.—A domestic producer that exports beer may 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 are 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. 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 current rules under which the Code permits tax-free removals of alcoholic beverages (or allows a credit or refund of tax on a return to bonded premises) result in inappropriate disparities in the treatment of different types of alcoholic beverages. In addition, these rules unduly limit 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 current law (i.e., the sign requirement and the sugar limits for certain wine) are outdated and should be 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 requirement is 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 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 Treasury'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 regulations, beer imported in bulk may be withdrawn from customs custody and transferred in bulk to a brewery 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 will be liable for the tax imposed on the withdrawal from customs custody and the importer will be 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 90 days after the date of enactment.

4. Authority for Internal Revenue Service to grant exemptions from excise tax registration requirements (sec. 1431 of the bill and sec. 4222 of the Code)

Present 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 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

Allowing the IRS to waive the registration requirement for purchasers and second purchasers in all cases will 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.

5. Repeal of excise tax deadwood provisions (sec. 1432 of the bill and secs. 4051, 4495–4498, and 4681–4682 of the Code)

Present Law

The Code includes 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 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 are effective on the date of enactment.

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 bill and sec. 148 of Code)

Present 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.

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 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.

2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules (sec. 1442 of the bill and sec. 148 of the Code)

Present 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, 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 bill 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.

3. Repeal of debt service-based limitation on investment in certain nonpurpose investments (sec. 1443 of the bill and sec. 148 of the Code)

Present 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, present law also limits 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 affects primarily investments in reasonably required reserve or replacement funds. Present 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 bill repeals the 150-percent of debt service yield restriction.

Effective Date

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

4. Repeal of expired provisions relating to student loan bonds (sec. 1444 of the bill and sec. 148 of the Code)

Present Law

Present law includes 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. It has no effect on bonds issued prior to the date of enactment.

C. TAX COURT PROCEDURES

1. Overpayment determinations of Tax Court (sec. 1451 of the bill and sec. 6512 of the Code)

Present 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 bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill 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 is effective on the date of enactment.

2. Redetermination of interest pursuant to motion (sec. 1452 of the bill and sec. 7481 of the Code)

Present 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

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 bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The provision is effective on the date of enactment.

3. Application of net worth requirement for awards of litigation costs (sec. 1453 of the bill and sec. 7430 of the Code)

Present 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. 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 bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worth of both spouses is aggregated for purposes of this computation. An exception to this rule is provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

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

4. Tax Court jurisdiction for determination of employment status (sec. 1454 of the bill and new sec. 7435 of the Code)

Present 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

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 bill 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 (a) one or more individuals performing services for that person are employees of that person or (b) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court would have 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.[20]

The bill provides for de novo review (rather than review of the administrative record). Assessment and collection of the tax 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 eligi-

[20] See Annoucement 96–13 and Announcement 97–52.

ble taxpayers with respect to Tax Court determinations pursuant to the bill. The bill 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 takes effect on the date of enactment.

D. OTHER PROVISIONS

1. Due date for first quarter estimated tax payments by private foundations (sec. 1461 of the bill and sec. 6655 of the Code)

Present 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 (UBIT) liability under section 511).[21] 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 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, the due date of a foundation's first-quarter estimated tax payment should be the same date for filing the foundation's annual return (Form 990–PF) for the preceding year.

Explanation of Provision

The bill 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 the date of enactment.

[21] 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 he foundation's Form 990–PF, or (2) 95 percent of the foundation's current-year tax liability.

2. Withholding of Commonwealth income taxes from the wages of Federal employees (sec. 1462 of the bill and sec. 5517 of title 5, United States Code)

Present 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 Committee believes that employees of the United States should be in no better or worse position than other employees vis-a-vis local withholding.

Explanation of Provision

The bill 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 January 1, 1998.

3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments (sec. 1463 of the bill and sec. 6621 of the Code)

Present 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 exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income 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.

TECHNICAL CORRECTIONS TO THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

A. SMALL BUSINESS-RELATED PROVISIONS

1. Returns relating to purchases of fish (sec. 1501(a)(1) of the bill and sec. 6050R(c)(1) of the Code)

Present 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. 1502(c)(1) of the bill and sec. 1361(c)(1)(B) of the Code)

Present Law

Under present 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.

Description 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. 1501(c)(2) of the bill)

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination 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. 1501(c)(3) of the bill and sec. 1361(b)(3) of the Code)

Present 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. 1501(d)(1)(B) of the bill and sec. 408(k)(6) of the Code)

Present 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 bill 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

a. Reporting requirements for SIMPLE IRAs (sec. 1501(d)(1)(A) of the bill and sec. 408(i) of the Code)

Present 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 bill conforms the time for providing reports for SIMPLE IRAs to that for IRA reports generally. Thus, the bill 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. 1501(d)(1)(C) of the bill and secs. 408(l)(2) and 6693(c) of the Code)

Present 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 bill 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. 1501(d)(1)(D) of the bill and sec. 408(p) of the Code)

Present 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 bill 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. 1501(d)(1)(E) of the bill and sec. 408(p)(2)(D) of the Code)

Present 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 bill 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. 1501(d)(1)(F) of the bill and sec. 408(p)(2) of the Code)

Present 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 bill 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. 1501(d)(2)(A) of the bill and sec. 401(k)(11)(D) of the Code)

Present 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 bill 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. 1501(d)(2)(B) of the bill and sec. 401(k)(11) of the Code)

Present 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 bill 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. 1501(d)(2)(C) of the bill and sec. 404(a)(3) of the Code)

Present 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 bill 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 is deductible by the employer for the taxable year.

i. Notification and election periods for SIMPLE 401(k) arrangements (sec. 1501(d)(2)(D) of the bill and sec. 401(k)(11) of the Code)

Present 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 bill extends the employer notice and employee election requirements of SIMPLE IRAs to SIMPLE 401(k) arrangements.

Effective Date

The bill is effective with respect to calendar years beginning after the date of enactment.

j. Treatment of Indian tribal governments under section 403(b) (sec. 1501(d)(5) of the bill and sec. 403(b) of the Code)

Present 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 bill 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.

C. FOREIGN PROVISIONS

1. Measurement of earnings of controlled foreign corporations (sec. 1501(e) of the bill, subtitle E of the Act, and section 956 of the Code)

Present 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)(1) and accumulated earnings and profits referred to in section 316(a)(2). 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 for purposes of determining the CFC's earnings invested in United States property do not include current earnings (which are taken into account separately). 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. 1501(i)(2) of the bill, sec. 1903 of the Act, and sec. 679 of the Code)

Present 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. 1501(i)(3) of the bill, sec. 1907 of the Act, and secs. 641 and 7701(a)(30) of the Code)

Present 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.[1]

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.

[1] Notice 96–65, I.R.B. 1996–52. See Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 104th Congree" (JCS–12–96), December 12, 1996, pp. 277–278.

D. Excise Tax Provisions

1. Repeal "deadwood" provisions relating to previous allowance of advance refunds of diesel fuel tax (sec. 1501(f)(2) of the bill and sec. 9503 of the Code)

Present Law

The Small Business Tax Act repealed a provision allowing purchasers of diesel-powered automobiles and light trucks to claim a tax credit equal to an assumed amount of diesel fuel tax that they would pay over the life of the vehicle. Several accounting provisions in the Code's Highway Trust Fund that relate to this repealed provision were inadvertently retained.

Explanation of Provision

The bill repeals the Highway Trust Fund provisions relating to the diesel fuel advance refunds, as deadwood.

2. Phaseout and expiration of excise tax on luxury automobiles (sec. 1502(f)(3) of the bill and secs. 4001 and 4003 of the Code)

Present Law

Present law imposes an excise tax on the sale of automobiles whose price exceeds a designated threshold, currently $34,000. The excise tax 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 three percent in 2002. The $34,000 threshold is indexed for inflation.

The tax generally applies only to the first retail sale after manufacturer, 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 is imposed on the "separate purchase of vehicle and parts and accessories therefor" when the sum of the separate purchases exceeds the luxury tax threshold. The rate of tax under section 4003 is not determined by reference to section 4001.

The tax under sec. 4001 applies to sales before January 1, 2003. The tax under sec. 4003 has no termination date.

Explanation of Provision

The bill 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.

3. Clarify scope of aviation excise tax exemption for emergency medical aircraft (sec. 1501(f)(4) of the bill and sec. 4041 of the Code)

Present Law

The Small Business Tax Act provided that fixed-wing aircraft that are equipped for and exclusively dedicated to the provision of emergency medical services (i.e., air ambulances) are exempt from the aviation excise taxes.

Explanation of Provision

The bill clarifies that this exemption is applied on a flight-by-flight basis.

4. Clarify effective date of technical correction related to ethanol refunds (sec. 1501(g)(1) of the bill and sec. 6427 of the Code)

Present Law

Present law includes a 54-cents-per-gallon income tax credit for ethanol used as a motor fuel. This tax benefit may be claimed through reduced-rate gasoline sales or expedited refunds of gasoline tax paid when the ethanol is blended with gasoline. The Small Business Tax Act corrected a previous technical error in the expiration date of the expedited refund provision, but the correction inadvertently failed to include refunds for periods before its enactment.

Explanation of Provision

The bill clarifies that the technical correction relating to the expedited ethanol refunds was retroactive to the provision's expiration after September 30, 1995. Claims for refunds of tax paid during the period October 1, 1995, through the date of enactment of the Small Business Tax Act must be filed before 60 days after enactment of this bill.

E. OTHER PROVISIONS

1. Treatment of certain reserves of thrift institutions (sec. 1501(f)(5) of the bill and secs. 593(e) and 1374 of the Code)

Present 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 bill 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).

2. "FASIT" technical corrections (sec. 1501(f)(6) of the bill and sec. 860L of the Code)

Present 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)[2]; (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 bill 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 bill corrects an incorrect cross reference in section 860L(d) from section 860L(c)(2) to section 860L(b)(2).

Tax on prohibited transactions

The bill provides that the tax on prohibited transactions would not apply to dispositions of foreclosure property or hedges using the similar exception applicable to REMICs.

3. Qualified State tuition plans (sec. 1501(h)(1) of the bill and sec. 529 of the Code)

Present Law

Section 529 provides tax-exempt status to certain qualified State tuition programs and provides rules for 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 1996, but a special transition rule provides that if (1) a State maintains (on the date of enactment) a program under which persons

[2] 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).

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 (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).

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.

4. Adoption credit (sec. 1501(h)(2) of the bill, sec. 1807 of the Small Business Act, and sec. 23 of the Code)

Present 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.

5. Phaseout of adoption assistance exclusion (sec. 1501(h)(2) of the bill, sec. 1807 of the Small Business Act, and sec. 137 of the Code)

Present 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.

HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996

1. Medical savings accounts (sec. 1502(a) of the bill and sec. 220 of the Code)

a. Additional tax on distributions not used for medical purposes

Present Law

Under present 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 bill provides that the 15-percent tax on nonmedical withdrawals from an MSA is not treated as tax liability for purposes of the minimum tax.

b. Definition of permitted coverage

Present Law

Under present 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 bill, Medicare supplemental plans would be deleted from the types of permitted coverage an individual may have and still qualify for an MSA.

c. Taxation of distributions

Present Law

Under present 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 bill 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.

d. Penalty for failure to provide required reports

Present 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. Under present law, separate penalties apply to information returns required by the Code.

Explanation of Provision

The bill provides that the $50 penalty does not apply to information returns.

2. Definition of chronically ill individual under a qualified long-term care insurance contract (sec. 1502(b) of the bill and sec. 7702B(c)(2) of the Code)

Present 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.

3. Deduction for long-term care insurance of self-employed individuals (sec. 1502(c) of the bill and sec. 162(l)(2) of the Code)

Present Law

Present law provides that 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. Present law also provides that 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.

4. Applicability of reporting requirements of long-term care contracts and accelerated death benefits (sec. 1502(d) of the bill and sec. 6050Q of the Code)

Present Law

Present law provides that 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.

Present law also provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amounts received for the sale or assignment of any portion of the death benefit under a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill (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.

5. Consumer protection provisions for long-term care insurance contracts (sec. 1502(e) of the bill and sec. 7702B(g)(4)(b) of the Code)

Present Law

The long-term care insurance rules of present law 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.

6. Insurable interests under the COLI provision (sec. 1502(f)(1) of the bill and sec. 264(a)(4) of the Code)

Present 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.

7. Applicable period for purposes of applying the interest rate for a variable rate contract under the COLI rules (sec. 1502(f)(2) of the bill and sec. 264(d)(2)(B)(ii) of the Code)

Present 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.

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.

8. Definition of 20-percent owner for purposes of key person exception under COLI rule (sec. 1502(f)(3) of the bill and sec. 264(d)(4) of the Code)

Present 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.

9. Effective date of interest rate cap on key persons and pre-1986 contracts under the COLI rule (sec. 1502(f)(4) of the bill and sec. 501(c) of HIPA)

Present 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.

10. Clarification of contract lapses under effective date provisions of the COLI rule (sec. 1502(f)(5) of the bill and sec. 501(d)(2) of HIPA)

Present 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).

Present law provides that the 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 of present law, 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 of present law are not to apply solely by reason of a lapse occurring by reason of no additional premiums being received under the contract after October 13, 1995.

11. Requirement of gain recognition on certain exchanges (sec. 1502(g) (1) and (2) of the bill, sec. 511 of the Act, and sec. 877(d)(2) of the Code)

Present 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.

12. Suspension of 10-year period in case of substantial diminution of risk of loss (sec. 1502(g)(3) of the bill, sec. 511 of the Act, and sec. 877(d)(3) of the Code)

Present 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.

13. Treatment of property contributed to certain foreign corporations (sec. 1502(g)(4) of the bill, sec. 511 of the Act, and sec. 877(d)(4) of the Code)

Present 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.

14. Credit for foreign estate tax (sec. 1502(g)(6) of the bill, sec. 511 of the Act, and sec. 2107(c) of the Code)

Present 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.

TECHNICAL CORRECTIONS TO THE TAXPAYER BILL OF RIGHTS 2

1. Reasonable cause abatement for first-tier intermediate sanctions excise tax (sec. 1503(a) of the bill and section 4962 of the Code)

Present 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.[3] However, the abatement rules of section 4962 apply 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 means that IRS does not have such abatement authority with respect to the section 4958 excise taxes.

Explanation of Provision

The bill 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.

2. Reporting by public charities with respect to intermediate sanctions and certain other excise tax penalties (sec. 1503(b) of the bill and sec. 6033 of the Code)

Present 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.

[3] See Ways and Means Committee Report 104–506 accompanying H.R. 2377, p. 59.

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.[4]

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 are 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 does 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 bill 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 organization manager of the organization. In addition, the bill 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 bill 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.

[4] A separate provision in the bill makes a technical correction to section 4962(b) to permit the abatement of first-tier penalty excise taxes imposed under section 4958.

TECHNICAL CORRECTIONS TO OTHER ACTS

1. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act (sec. 1504(b)(3) of the bill and sec. 1449(a) of the Small Business Act)

Present 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 bill 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).

2. Clarify definition of Indian reservation under section 168(j)(6) (sec. 1504(c) of the bill and sec 168(j)(6) of the Code)

Present Law

Section 168(j)(6) provides for accelerated depreciation for certain property located on Indian reservations. For this purpose, provides that 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 51.

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.

3. Related parties determined by reference to section 267 (sec. 1504(e) of the bill and sec. 267(f) of the Code)

Present 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.

III. VOTES OF THE COMMITTEE

In compliance with clause 2(l)(2)(B) of rule XI of the Rules of the House of Representatives, the following statements are made concerning the votes of the Committee on Ways and Means in its consideration of budget reconciliation revenue recommendations.

Motion to report budget reconciliation revenue recommendations

The Committee's budget reconciliation revenue recommendations were ordered favorably reported on June 13, 1997, by a rollcall vote of 22 yeas to 16 nays (with a quorum being present). The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer	X			Mr. Rangel		X	
Mr. Crane	X			Mr. Stark		X	
Mr. Thomas	X			Mr. Matsui		X	
Mr. Shaw	X			Mrs. Kennelly		X	
Mrs. Johnson	X			Mr. Coyne		X	
Mr. Bunning	X			Mr. Levin		X	
Mr. Houghton	X			Mr. Cardin		X	
Mr. Herger	X			Mr. McDermott			
Mr. McCrery	X			Mr. Kleczka		X	
Mr. Camp	X			Mr. Lewis		X	
Mr. Ramstad	X			Mr. Neal		X	
Mr. Nussle		X		Mr. McNulty		X	
Mr. Johnson	X			Mr. Jefferson		X	
Ms. Dunn	X			Mr. Tanner		X	
Mr. Collins	X			Mr. Becerra		X	
Mr. Portman	X			Mrs. Thurman		X	
Mr. English	X						
Mr. Ensign	X						
Mr. Christensen	X						
Mr. Watkins	X						
Mr. Hayworth	X						
Mr. Weller	X						
Mr. Hulshof	X						

Votes on amendments

An amendment by Mrs. Kennelly to Title I of the Chairman's Mark to strike the offset to the child credit equal to 50 percent of the dependent care credit and strike the provision that would provide a special tax rate for capital gains for corporations was defeated by a rollcall vote of 16 yeas to 22 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark			
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson	X			Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Matsui to Title I to require that the child credit be taken on the tax return (i.e., "stacked") before the earned income tax credit and strike Part II of Subtitle B of Title III (relating to corporate capital gains) and impose a capital gains benefit recapture tax was defeated by a rollcall vote of 15 yeas to 23 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark			
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. McDermott to Title I to strike the child credit and replace it with a family credit that would be allowed against income taxes and social security taxes, and phased out for upper income taxpayers was defeated by a rollcall vote of 15 yeas to 23 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark			
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Rangel to Title II to strike all the education incentive provisions and insert the Hope credit as proposed by the Administration with modifications was defeated by a rollcall vote of 15 yeas to 21 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton				Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson				Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra			
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Kleczka to Title II to extend permanently the exclusion for employer-provided educational assistance and strike the corporate capital gains tax reduction was defeated by a rollcall vote of 16 yeas to 23 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Cardin to Title II to limit contributions to an education investment account and provide a tax credit for tutoring programs for grades K through 12 was agreed to by a rollcall vote of 22 yeas to 17 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton	X			Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle	X			Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins	X			Mr. Becerra	X		
Mr. Portman	X			Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign	X						
Mr. Christensen	X						
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. McDermott to Title III to provide an increase to 100 percent of health insurance deductibility for self-employed and strike the provision relating to a reduction of alternative capital gains tax for corporations was defeated by a rollcall vote of 15 yeas to 22 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra			
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. McDermott to Title III to increase over the 10 years the standard deduction for joint returns so that it equals twice the amount allowed for single taxpayers, and strike the corporate AMT provisions, corporate capital gains, and independent contractor “safe harbor,” and impose a capital gains tax reduction recapture tax was defeated by a rollcall vote of 13 yeas to 24 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin		X	
Mr. Houghton		X		Mr. Cardin		X	
Mr. Herger		X		Mr. McDermott	X		
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson				Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra			
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Jefferson to Title III to reduce the real estate depreciation recapture rate to 22 percent for years 1997 through 2002 and to 20 percent thereafter and strike the corporate capital gains tax rate reduction was defeated by a rollcall vote of 14 yeas to 23 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin		X	
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins							
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mrs. Thurman to Title III to impose a 1.4 percent "medicare taxes" on capital gains from the sale of securities and dedicate the proceeds to the Medicare Trust Fund was defeated by a rollcall vote of 12 yeas to 26 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly		X	
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal		X	
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner		X	
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Nussle and Mr. Tanner to Title III to strike section 1043 of the Mark relating to the reduction of incentives for alcohol fuels and limit the reduction in corporate capital gains rates was defeated by a rollcall vote of 17 yeas to 21 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark		X	
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly		X	
Mrs. Johnson		X		Mr. Coyne		X	
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp	X			Mr. Lewis		X	

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Ramstad	X			Mr. Neal		X	
Mr. Nussle	X			Mr. McNulty		X	
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra		X	
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen	X						
Mr. Watkins	X						
Mr. Hayworth	X						
Mr. Weller	X						
Mr. Hulshof	X						

An amendment by Messrs. Matsui, Stark, and Kleczka to Title IX to strike section 934 of the Mark relating to an independent contractor “safe harbor” was defeated by a rollcall vote of 15 yeas to 20 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane				Mr. Stark			
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson	X			Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton	X			Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner			
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Bunning to Title IX to modify passive loss limitations relating to equine activities and to limit the corporate capital gains reduction was defeated by a rollcall vote of 16 yeas to 22 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer	X			Mr. Rangel		X	
Mr. Crane		X		Mr. Stark		X	
Mr. Thomas	X			Mr. Matsui		X	
Mr. Shaw		X		Mrs. Kennelly		X	
Mrs. Johnson	X			Mr. Coyne		X	
Mr. Bunning	X			Mr. Levin.		X	
Mr. Houghton	X			Mr. Cardin		X	
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka		X	
Mr. Camp		X		Mr. Lewis		X	
Mr. Ramstad		X		Mr. Neal		X	
Mr. Nussle		X		Mr. McNulty	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Johnson	X			Mr. Jefferson		X	
Ms. Dunn	X			Mr. Tanner		X	
Mr. Collins	X			Mr. Becerra		X	
Mr. Portman	X			Mrs. Thurman	X		
Mr. English	X						
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Stark to Title X to provide a tax credit of up to 90 percent to subsidize the cost of private insurance for uninsured children and increase the tax on tobacco products was defeated by a rollcall vote of 13 yeas to 25 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson	X			Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka		X	
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson		X	
Ms. Dunn		X		Mr. Tanner		X	
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

An amendment by Mr. Hayworth to Title X to repeal the treatment of Indian tribal organizations under the unrelated business income tax and increase the tax on international air arrivals and departures was agreed to by a rollcall vote of 22 yeas to 16 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson	X			Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton	X			Mr. Cardin	X		
Mr. Herger		X		Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp	X			Mr. Lewis	X		
Mr. Ramstad	X			Mr. Neal	X		
Mr. Nussle	X			Mr. McNulty	X		

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English	X						
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth	X						
Mr. Weller		X					
Mr. Hulshof		X					

An amendment, in the nature of a substitute, by Mr. Rangel was defeated by a rollcall vote of 15 yeas to 22 nays. The vote was as follows:

Representatives	Yea	Nay	Present	Representatives	Yea	Nay	Present
Mr. Archer		X		Mr. Rangel	X		
Mr. Crane		X		Mr. Stark	X		
Mr. Thomas		X		Mr. Matsui	X		
Mr. Shaw		X		Mrs. Kennelly	X		
Mrs. Johnson		X		Mr. Coyne	X		
Mr. Bunning		X		Mr. Levin	X		
Mr. Houghton		X		Mr. Cardin	X		
Mr. Herger				Mr. McDermott			
Mr. McCrery		X		Mr. Kleczka	X		
Mr. Camp		X		Mr. Lewis	X		
Mr. Ramstad		X		Mr. Neal	X		
Mr. Nussle		X		Mr. McNulty	X		
Mr. Johnson		X		Mr. Jefferson	X		
Ms. Dunn		X		Mr. Tanner	X		
Mr. Collins		X		Mr. Becerra	X		
Mr. Portman		X		Mrs. Thurman	X		
Mr. English		X					
Mr. Ensign		X					
Mr. Christensen		X					
Mr. Watkins		X					
Mr. Hayworth		X					
Mr. Weller		X					
Mr. Hulshof		X					

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATES OF BUDGETARY EFFECTS

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the estimated budget effects of the Committee's revenue reconciliation provisions for fiscal years 1997–2007:

ESTIMATED BUDGET EFFECTS OF RECOMMENDATIONS TO THE HOUSE COMMITTEE ON THE BUDGET WITH RESPECT TO REVENUE RECONCILIATION PROVISIONS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS

Fiscal Years 1997 - 2007

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
I. CHILD AND DEPENDENT CARE TAX CREDITS; HEALTH CARE FOR CHILDREN														
1. Tax credit for children under age 17 ($400 in 1998 and $500 thereafter); $75,000/$110,000 AGI phaseout for credit [1].......................................	1/1/98	---	-2,282	-15,340	-18,187	-17,863	-17,584	-16,263	-15,997	-15,426	-15,055	-14,347	-71,257	-148,346
2. Index dependent care tax credit expense limit; $75,000/$110,000 AGI phaseout............................	1/1/98	---	8	47	19	-38	-69	-124	-164	-214	-285	-370	-33	-1,189
3. Expand State high-risk pools to include children of high-risk individuals..	tyba 12/31/97	---	[2]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
SUBTOTAL OF CHILD AND DEPENDENT CARE TAX CREDITS; HEALTH CARE FOR CHILDREN............................		---	-2,274	-15,294	-18,169	-17,902	-17,654	-16,388	-16,162	-15,641	-15,341	-14,718	-71,293	-149,542
II. EDUCATION TAX INCENTIVES														
A. Tax Benefits Relating to Education Expenses														
1. Administration's HOPE scholarship tax credit as modified - drop B average requirement; credit is 50% of up to $3,000 out-of-pocket tuition expenses and books required for attendance (phaseout $40,000 - $50,000 singles/ $80,000 - $100,000 joint)............................	tyba 12/31/97	---	-1,745	-5,012	-5,091	-5,173	-5,258	-5,338	-5,404	-5,471	-5,540	-5,610	-22,278	-49,640
2. Deduction for undergraduate tuition, room, and board expenses paid through State-sponsored prepaid tuition programs; limit deduction to $10,000 per student per year, with aggregate maximum deduction of $40,000 per student............	tyba 12/31/97	---	-60	-179	-196	-216	-238	-261	-288	-316	-348	-383	-889	-2,485
3. Penalty-free withdrawals from all IRAs for undergraduate, post-secondary vocational, and graduate education expenses..........................	1/1/98	---	-72	-213	-200	-149	-125	-114	-98	-93	-92	-91	-758	-1,246

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
B. Expanded Education Investment Savings Opportunities														
1. Permit contributions to an education investment account for a child under age 18 (annual contributions limited to $5,000); create private prepaid tuition programs; provide deduction for undergraduate and post-secondary vocational tuition, room, and board expenses paid through education investment accounts or private prepaid tuition programs; limit deductions to $10,000 per student per year with aggregate maximum deduction of $40,000 per student [3]........	tyba 12/31/97	---	-339	-1,067	-1,568	-1,879	-1,793	-1,852	-2,445	-2,978	-3,487	-3,998	-6,665	-21,423
C. Other Education Tax Provisions														
1. Extend employer-provided education assistance for undergraduates through 12/31/97 [1]................	tyba 12/31/96	---	-171	---	---	---	---	---	---	---	---	---	-171	-171
2. Raise $150 million volume cap on 501(c)(3) bonds (other than hospital bonds) by $10 million per year until it reaches $200 million.......................	1/1/98	---	-2	-14	-27	-37	-46	-50	-51	-54	-59	-70	-126	-410
3. Enhanced deduction for corporate contributions of computer technology and equipment for grades K - 12..................................	tyba 12/31/97	---	-46	-48	-53	-58	-63	-69	-76	-83	-91	-100	-268	-688
4. Phase out qualified tuition reduction provided to employees of educational institutions (section 117(d)); phaseout benefits - 80% in 1998, 60% in 1999, 40% in 2000, 20% in 2001, and repealed in 2002 (HOPE scholarship applies to balance)..	1/1/98	---	12	46	83	124	169	203	213	224	235	247	433	1,556
5. Administration's student loan repayment forgiveness proposal, with public service................	aiiia DOE	[4]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[5]	[5]
6. $150 credit for tutoring expenses............................	tyba 12/31/97	---	-20	-57	-58	-58	-59	-59	-60	-60	-61	-61	-252	-553
SUBTOTAL OF EDUCATION TAX INCENTIVES...		[4]	-2,443	-6,564	-7,110	-7,446	-7,413	-7,540	-8,209	-8,831	-9,443	-10,066	-30,974	-75,080
III. SAVINGS AND INVESTMENT TAX INCENTIVES														
A. Retirement Savings														
1. Create American Dream IRAs; allow penalty-free rollovers from IRAs; allow special purpose withdrawals from AD IRAs for first-time home purchase [6]..	1/1/98	---	-184	534	436	-534	-286	-519	-1,683	-2,524	-3,576	-4,633	-33	-12,968

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Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
B. Capital Gains Provisions														
1. Capital gains: (a) 20/10% rate structure; (b) collectibles get 28%; (c) section 1250 recapture at maximum of 26%; (d) symmetric AMT treatment; (e) indexing starting in 2001, 3-year post-2000 holding period requirement , with mark-to-market; (f) exemption for gain on principal residence including remainder interests ($250,000 single/$500,000 joint returns); (g) 32% rate in 1998, 31% in 1999, and 30% thereafter for corporate gains with 8-year holding period (effective 1/1/98); and (h) allow ordinary losses to offset capital gains of corporations (effective 1/1/98)	generally 5/7/97	1,659	6,288	-456	-3,673	-3,635	2,505	-4,939	-5,874	-7,118	-8,871	-10,741	2,688	-34,855
SUBTOTAL OF SAVINGS AND INVESTMENT TAX INCENTIVES		1,659	6,104	78	-3,238	-4,169	2,219	-6,456	-7,557	-9,842	-12,447	-15,374	2,655	-47,823
IV. ALTERNATIVE MINIMUM TAX PROVISIONS														
1. AMT - Increase individual exemption amount by $1,000 every other year 1999 through 2007, index thereafter	tyba 12/31/98	---	---	-53	-219	-352	-672	-1,023	-1,705	-2,440	-3,755	-5,138	-1,296	-15,357
2. Exemption from alternative minimum tax for small corporations	tyba 12/31/97	---	-97	-171	-131	-100	-77	-59	-45	-34	-26	-20	-577	-782
3. Prospective repeal of AMT depreciation adjustment	ppisa 1/1/99	---	---	-1,265	-3,312	-3,901	-3,296	-2,693	-2,251	-1,912	-1,790	-1,770	-11,774	-22,190
4. Reverse IRS position on AMT treatment of certain installment sales by farmers	tyba 12/31/87	-8	-157	-158	-167	-164	-157	-148	22	22	21	21	-811	-872
SUBTOTAL OF ALTERNATIVE MINIMUM TAX PROVISIONS		-8	-254	-1,847	-3,829	-4,517	-4,202	-3,923	-3,979	-4,364	-5,550	-6,907	-14,458	-39,201
V. ESTATE, GIFT AND GENERATION-SKIPPING TAX PROVISIONS														
A. Estate and Gift Tax Provisions														
1. Increase unified estate and gift tax credit to $650,000 in 1998; $750,000 in 1999; $765,000 in 2000; $775,000 in 2001 through 2004, $800,000 in 2005, $825,000 in 2006; and $1 million in 2007; and index other provisions beginning in 1999	dda 12/31/97	---	---	-650	-2,004	-2,303	-2,588	-2,788	-3,463	-3,688	-4,200	-5,317	-7,545	-27,001
2. 20-year installment payment where estate consists largely of interest in closely held business	dda 12/31/97	---	---	---	---	---	---	-14	-10	-7	-5	-2	---	-38
3. Reduced rate on all, and no interest on certain portion of, estate tax extended under section 6166	dda 12/31/97	---	---	-10	-20	-32	-45	-59	-73	-88	-103	-119	-107	-549

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
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	-60	-127
5. 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	-33	-43
6. 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	-81	-310
7. Repeal certain throwback rules applicable to domestic trusts..	tyba 12/31/97	---	---	-20	-20	-20	-20	-20	-20	-20	-20	-20	-80	-180
8. Unified credit of decedent increased by unified credit of spouse used on split gift included in decedent's gross estate...	gma DOE	---	-9	-10	-10	-11	-11	-12	-12	-13	-13	-14	-51	-115
9. Reformation of defective bequests, etc. to spouse of decedent..	dda DOE	---	-11	-12	-13	-13	-14	-15	-15	-16	-17	-18	-63	-144
B. Generation-Skipping Tax Provisions														
1. Severing of trusts holding property having an inclusion ratio of greater than zero..........................	sa DOE	---	---	-6	-6	-6	-7	-7	-7	-7	-7	-7	-25	-60
2. Expansion of exception from generation-skipping transfer tax for transfers to individuals with deceased parents..........................	gsta DOE	---	---	-4	-4	-4	-4	-4	-5	-5	-5	-6	-16	-41
SUBTOTAL OF ESTATE, GIFT AND GENERATION-SKIPPING TAX PROVISIONS...		---	-45	-745	-2,112	-2,427	-2,732	-2,968	-3,660	-3,905	-4,437	-5,577	-8,061	-28,608
VI. EXPIRING TAX PROVISIONS														
1. Research tax credit (through 12/31/98)...................	6/1/97	-161	-1,062	-1,091	-470	-314	-211	-66	---	---	---	---	-3,309	-3,375
2. Contributions of appreciated stock to private foundations (through 12/31/98)...............................	6/1/97	---	-80	-61	-9	-2	---	---	---	---	---	---	-151	-151
3. Extend a modified work opportunity tax credit for one year (through 9/30/98); make the WOTC an exception to the calculation of the AMT (effective taxable years beginning after 12/31/97) [7]...	wpoifhma 9/30/97	---	-243	-179	-76	-18	-1	3	2	---	---	---	-519	-512
4. Orphan drug tax credit (permanent)........................	6/1/97	---	-29	-28	-30	-32	-34	-35	-37	-39	-40	-42	-152	-346
SUBTOTAL OF EXPIRING TAX PROVISIONS..		-161	-1,414	-1,359	-585	-366	-246	-98	-35	-39	-40	-42	-4,131	-4,384
VII. DISTRICT OF COLUMBIA TAX INCENTIVES [8]														
1. Designate existing D.C. enterprise community and census tracts with greater than 35% poverty 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	---	-12	-20	-21	-23	-25	-12	-3	-3	-3	-3	-101	-124
2. Provide 0% capital gains rate on enterprise zone business property in the D.C. Enterprise Zone held for at least 5 years; sunset 12/31/02.......	1/1/98	---	[2]	-1	-2	-3	-4	-5	-5	-6	-6	-6	-9	-40
3. $75 million in tax credits to taxpayers that provide equity and loans to certain D.C. businesses...	1/1/98	---	-5	-10	-20	-25	-10	-2	-2	-1	[2]	[2]	-70	-75

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
4. Reduce 15% income tax bracket to 10% for residents of new D.C. Enterprise Zone	1/1/98	---	-18	-28	-30	-31	-33	-35	-36	-38	-40	-42	-141	-332
SUBTOTAL OF DISTRICT OF COLUMBIA TAX INCENTIVES		—	-35	-59	-73	-82	-72	-54	-46	-48	-49	-53	-321	-571
VIII. WELFARE-TO-WORK TAX CREDIT														
1. Administration's welfare-to-work 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 before 4/30/99	wpoifhma 12/31/97	---	-13	-31	-29	-15	-10	-4	-2	-1	---	---	-99	-106
SUBTOTAL OF WELFARE-TO-WORK TAX CREDIT		—	-13	-31	-29	-15	-10	-4	-2	-1	—	—	-99	-106
IX. MISCELLANEOUS PROVISIONS														
A. Provisions Relating to Excise Taxes														
1. Repeal excise tax on recreational motorboat diesel fuel	1/1/98	---	-4	-5	-5	-1	-1	-1	-1	-1	-1	-1	-16	-22
2. Modify excise tax on imported halons	DOE	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	1	1
B. Provisions Relating to Disasters														
1. Disaster losses: postponement of IRS deadlines and loss valuation	aoty							*Negligible Revenue Effect*						
2. 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	-18	-23
3. Loosen mortgage revenue bond requirements in disaster areas for 1997 through 1999	bia 12/31/96	---	-1	-5	-8	-8	-9	-7	-6	-6	-5	-4	-31	-59
C. Provisions Relating to Employment Taxes														
1. Independent contractor for bakery drivers	spa 12/31/97	—	-13	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	-15	-18
2. Independent contractor for securities brokers	spi tyba 12/31/97							*Negligible Revenue Effect*						
3. SECA for insurance agents	pa 12/31/97							*Negligible Revenue Effect*						
4. Safe harbor for independent contractors [11]	pa 12/31/97	—	-191	-203	-202	-206	-210	-214	-224	-233	-239	-283	-1,012	-2,205
D. Provisions Relating to Small Businesses														
1. Delay imposition of penalties for failure to make payments electronically through EFTPS until after 12/31/98	7/1/97	---	-904	904	—	---	---	---	---	---	---	---	---	---
2. Definition of principal place of business for home office deduction	tyba 12/31/97	---	-114	-234	-244	-253	-263	-274	-285	-295	-306	-318	-1,109	-2,587
E. Provisions Relating to Pensions														
1. Water districts made eligible for 401(k) plans even if State or local entity	1/1/98	---	[10]	-1	-1	-1	-2	-2	-2	-2	-2	-3	-6	-15
2. Modify section 415 limits for certain State and local plans	tyba 12/31/97	—	-9	-25	-25	-26	-26	-26	-27	-27	-27	-28	-111	-246
3. Extend moratorium on nondiscrimination rules for public pension plans (permanent)	DOE							*Negligible Revenue Effect*						
4. Treatment of certain disability benefits received by former police officers or firefighters	DOE	—	-11	—	---	---	—	—	---	—	—	---	-11	-11

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Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
5. Estate tax relief for money going to ESOPs in existence on 8/1/96 and decedents dying before 1/1/99	DOE	---	-8	-15	---	---	---	---	---	---	---	---	-23	-23
6. ESOP technicals	tyba 12/31/97	Negligible Revenue Effect												
7. Increase the amount from $3,500 to $5,000 on involuntary cash out from pension plans	dma DOE	[9]	2	6	7	7	7	8	8	9	9	10	29	73
8. Noncommercial aircraft flight fringe benefit	tyba 12/31/97	---	-3	-4	-4	-4	-4	-4	-4	-4	-4	-4	-19	-39
F. Trade Provision: 2-year GSP Extension [12]	**6/1/97**	**---**	**-464**	**-216**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-680**	**-680**
G. Extend CBI Parity Through 12/31/98 [12]	**1/1/98**	**---**	**-160**	**-57**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-217**	**-217**
H. Other Provisions														
1. Shrinkage allowance for inventory accounting	---	---	-7	-21	-23	-25	-27	-29	-31	-33	-35	-37	-103	-268
2. Include liability to pay compensation under workmen's compensation acts within rules relating to certain personal liability assignments	cla DOE	---	-1	-2	-5	-8	-12	-17	-23	-29	-32	-36	-27	-164
3. Grandfather publicly traded partnerships with tax on gross receipts to make revenue neutral	tyba 12/31/97	Revenue Neutral												
4. Exclusion from UBTI for certain corporate sponsorship payments	pra 12/31/97	Negligible Revenue Effect												
5. Allow timeshare associations to elect to be taxed as homeowner associations at 32%	tyba 12/31/96	Negligible Revenue Effect												
6. Allow refunding of certain tax-exempt Virgin Islands bonds [13]	bia DOE	---	-2	-4	-5	-5	-5	-3	-1	-3	-4	-4	-21	-37
7. Restore the business meals deduction to 80% in 5% increments every other year for persons subject to Federal hours of service limitation	tyba 12/31/97	---	-8	-17	-27	-37	-49	-62	-76	-91	-108	-125	-138	-600
8. Clarify tax-exempt status of certain State workmen's compensation funds	tyba 12/31/97	---	[2]	[2]	-1	-1	-1	-1	-1	-1	-1	-1	-2	-6
9. 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	sea 12/31/97	---	-2	-5	-5	-5	-4	-4	-4	-4	-4	-4	-21	-41
10. Treatment of consolidation of certain mutual savings bank life insurance departments	12/31/91	---	-25	-9	-9	-9	-9	-9	-6	-6	-6	-6	-61	-96
11. Modification to the OECD Shipbuilding Trade Agreement - extend 1 year from DOE [12]	---	---	-8	---	---	---	---	---	---	---	---	---	-8	-8
12. 109% prior year safe harbor	---	-481	481	---	---	---	---	---	---	---	---	---	---	---
13. Exempt from income taxation income earned by law enforcement officers killed in the line of duty during the year of their death	tyba 12/31/96	---	-2	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-11
14. Exemption for incremental cost of clean-fuel vehicle from luxury tax and limits on depreciation	DOE	[2]	-1	-1	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-2	-2
15. Repeal 65% net income limitation with respect to percentage depletion related to marginal production	tyba DOE	---	-64	-77	-23	---	---	---	---	---	---	---	-164	-164

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
16. Treat certain gasoline retailers as wholesale distributors under gasoline tax refund rules	DOE	Negligible Revenue Effect												
SUBTOTAL OF MISCELLANEOUS PROVISIONS		-481	-1,531	6	-583	-585	-616	-647	-687	-728	-767	-846	-3,791	-7,468
X. REVENUE PROVISIONS														
A. Financial Products														
1. Constructive sales treatment for appreciated financial positions	cseia 6/8/97	---	367	121	68	73	79	85	91	98	105	112	708	1,199
2. Disallowance of interest on indebtedness allocable to tax-exempt obligations ($1 million de minimis)	tyba DOE oaa dofca	---	8	18	24	29	35	41	47	52	57	62	113	372
3. Gains or losses from certain terminations with respect to property	30da DOE	---	15	27	25	25	25	25	25	25	25	25	117	242
4. Determination of original issue discount where pooled debt obligations subject to acceleration	tyba DOE	---	76	275	358	319	283	100	105	109	114	118	1,311	1,857
5. Denial of interest deduction on certain debt instruments	iia 6/8/97	---	5	16	29	43	55	62	63	64	65	67	148	469
B. Corporate Organizations and Reorganizations														
1. Tax treatment of certain extraordinary dividends	da 5/3/95 or da 9/13/95	---	440	-90	-51	-7	42	71	77	82	89	95	334	748
2. Recognition of gain in certain section 355 transactions	da 4/16/97	---	567	330	289	248	206	165	124	83	41	3	1,640	2,056
3. Tax treatment of redemptions involving related corporations	da/a 6/8/97	---	10	10	5	5	5	5	5	5	5	5	35	60
4. Modify holding period for dividends-received deduction	droaa 30da DOE	---	12	15	15	16	16	16	17	17	17	18	74	159
C. Other Corporate Provisions														
1. Registration and other provisions relating to confidential corporate tax shelters	tsoaiTg	---	15	37	38	39	41	42	43	44	46	47	170	392
2. Certain preferred stock treated as "boot"	ta 6/8/97	---	35	37	39	41	43	10	10	11	11	12	194	248
D. Administrative Provisions														
1. Reporting of certain payments made to attorneys	pma 12/31/97	---	—	3	3	3	3	3	4	4	4	4	12	31
2. Decrease of threshold for reporting payments to corporations performing services for Federal agencies	rd 90da DOE	---	---	7	8	9	10	11	11	12	12	13	34	93
3. Disclosure of return information for administration of certain Veterans' programs [12]	dma 9/30/98	---	---	22	27	31	36	36	37	38	38	39	116	304
4. Modify levy exemption and provide continuous levy on certain payments	lia DOE	---	332	327	256	213	157	117	102	86	82	78	1,285	1,750
5. Consistency requirement for returns of beneficiaries of estates and trusts	rfa DOE	---	3	3	3	3	3	3	4	4	4	4	15	34
6. No information reporting on sales of principal residences less than $250,000 or $500,000 (married filing joint return)	DOE	Negligible Revenue Effect												

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
E. Excise Tax Provisions														
1. Extend and modify Airport Trust Fund excise taxes:														
a. Extend domestic air passenger ticket tax; reduce tax rate from 10% to 7.5% of ticket price; impose an additional tax of $2.00 per flight segment for 10/1/97 through 12/31/98, $2.25/segment in 1999, $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); and impose 7.5% tax on payments to airlines for air travel under credit card and similar programs	10/1/97	---	4,434	4,704	5,097	5,514	5,957	6,367	6,781	7,221	7,691	8,176	25,706	61,943
b. Modify airline ticket tax deposit rule to suspend deposits due 8/15/97 to 9/30/97 until 10/10/97	DOE	-1,017	1,017	---	---	---	---	---	---	---	---	---	---	---
c. Require breakout of airfare and tax in airline advertising	10/1/97						No Revenue Effect							
d. Extend current air cargo excise tax	10/1/97	---	304	347	377	409	443	481	522	567	615	667	1,880	4,732
e. Extend international departure fee, raise fee to $15.50/passenger, charge arrivals at the same fee rate, and index the $15.50 fee to changes in the CPI (first indexing adjustment on 1/1/99)	10/1/97	---	1,020	1,141	1,231	1,332	1,445	1,565	1,697	1,833	1,979	2,137	6,170	15,381
f. Extend current taxes on noncommercial aviation gasoline and jet fuel	10/1/97	---	84	87	89	91	93	95	97	99	102	104	446	943
g. Dedicate 4.3 cents/gallon of tax on aviation fuel to the Airport and Airway Trust Fund	10/1/97						No Revenue Effect							
2. Tax kerosene in the same manner as diesel fuel	7/1/98	---	44	43	49	46	44	43	44	47	49	52	226	461
3. Reduce ethanol tax credit and excise tax exemption from 54 to 51 cents/gallon; increase small producer credit from 10 to 13 cents/gallon; limit subsidy-eligible production to the producer's average production for 1993-1997; impose 51 cents/gallon penalty on excess production during periods when 51 cents/gallon subsidy is in effect, repeal all subsidies for ETBE (effective DOE), and repeal all subsidies after 12/31/00 [14]	1/1/98	---	60	88	95	422	547	556	565	574	584	594	1,212	4,085
4. Reinstate LUST excise tax and extend through 9/30/02	DOE	15	129	128	128	129	131	---	---	---	---	---	660	660
5. Flat excise tax on vaccines; allow new vaccines to be automatically covered ($0.84 per dose)	10/1/97	---	[9]	[2]	1	1	1	1	1	1	1	1	3	8
6. Excise tax on certain prepaid phone cards	DOE	---	19	28	38	49	60	71	83	101	113	124	193	684

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
F. 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 DOE & tyba 12/31/98	---	8	14	8	6	5	5	4	4	4	4	42	63
2. Carryover basis on sale of property by tax-exempt related party..........	sea 6/8/97	---	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	1	2
3. Extend reporting and proxy tax requirements for political and lobbying expenditures to all section 501(c) organizations except charitable organizations..........	tyba 12/31/97	---	4	4	5	5	5	5	5	5	6	6	23	50
4. Repeal 1986 Act grandfather rules for pension business of certain insurers..........	tyba 12/31/97	---	[9]	82	116	124	128	133	140	149	160	174	450	1,208
G. Other Revenue-Increase Provisions														
1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting..........	[15]	---	30	34	36	37	38	40	41	42	44	45	175	387
2. 2-year carryback and 20-year carryforward for net operating losses..........	NOLgi tyba DOE	---	44	319	380	289	168	143	118	105	98	95	1,200	1,759
3. Modification of treatment of company-owned life insurance - pro rata disallowance of interest on debt to fund life insurance..........	cia dofca	---	20	53	93	140	193	247	299	349	399	447	500	2,240
4. Modify the basis allocation rules for distributee partners..........	pda DOE	---	26	52	55	57	59	61	64	66	69	72	249	581
5. Eliminate the substantial appreciation requirement for inventory of a partnership..........	sepda DOE	---	32	66	69	73	77	80	84	89	93	98	317	761
6. Extend the 5-year time limit for taxing pre-contribution gain to 10 years..........	pcpa dofca	---	---	---	---	---	7	21	22	23	24	25	7	122
7. Restrict income forecast method and allow 3-year MACRS for rent-to-own property..........	tyba 12/31/97	---	29	41	62	78	38	27	25	17	17	18	249	351
8. Repeal 14-day rule on rental of vacation properties (section 280A)..........	tyba 12/31/97	---	23	23	24	26	27	28	29	30	31	33	123	274
9. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person..........	icoa dofca	---	1	4	6	8	11	13	15	17	19	21	30	115
10. Repeal installment sales grandfather rules of 1986 Act..........	tyba DOE	---	42	92	101	102	61	20	21	22	23	24	398	508
11. State and local tax refund offset..........	rda 12/31/97	---	2	2	2	3	3	3	3	3	3	3	12	27
SUBTOTAL OF REVENUE PROVISIONS..........		-1,002	9,257	8,510	9,196	10,011	10,600	10,797	11,425	12,098	12,839	13,622	46,580	107,358
XI. FOREIGN SIMPLIFICATION AND OTHER FOREIGN-RELATED PROVISIONS														
A. General Provisions														
1. Phase in eligibility of licenses of computer software for foreign sales corporation benefits..........	gra 12/31/97	---	-18	-30	-112	-171	-178	-189	-200	-225	-250	-275	-509	-1,648
2. Increase dollar limitation on section 911 exclusion and index after 2007..........	1/1/98	---	-15	-30	-50	-67	-82	-97	-103	-111	-119	-127	-244	-801

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
3. Simplify foreign tax credit limitation for individuals	tyba 12/31/97	---	[10]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-9
4. Simplify translation of foreign taxes	---	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]
5. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes	tyba 12/31/97	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	-1	-2
6. Simplify treatment of personal transactions in foreign currency	tyba 12/31/97	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	-1	-2
7. Delay change to foreign tax credit limitation for dividends from 10/50 companies	tyba 12/31/01	---	---	---	---	---	-32	-89	-91	-93	-95	-97	-32	-497
B. General Provisions Affecting Treatment of Controlled Foreign Corporations	various	---	-2	-5	-7	-9	-10	-10	-11	-12	-13	-14	-33	-93
C. Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap With Subpart F and to Allow Mark-to-Market Election	tyba 12/31/97	---	-23	-21	-22	-24	-25	-26	-27	-29	-31	-33	-115	-261
D. Simplify Formation and Operation of International Joint Ventures	various	---	[2]	[2]	-1	-1	-1	-1	-1	-1	-1	-2	-3	-9
E. Modification of Reporting Threshold for Stock Ownership of a Foreign Corporation	1/1/98	---	[10]	-1	-2	-2	-2	-2	-2	-3	-3	-3	-7	-20
F. Other Foreign Simplification Provisions														
1. Transition rule for certain trusts	aiii SBJPA	---	-1	-3	-5	-5	-5	-5	-5	-5	-5	-5	-19	-44
2. Simplify application of the stock and securities trading safe harbor	tyba 12/31/97	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
G. Other 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	92	202
2. Further restrict like-kind exchanges involving foreign personal property	Ta dolca	---	4	8	11	13	15	17	19	21	23	25	51	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	230	552
4. Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons	tyba 12/31/97	---	2	6	12	15	15	14	13	12	11	10	50	110
5. Limitation on treaty benefits for payments to hybrid entities	DOE	---	1	1	1	1	1	1	1	1	1	1	5	10
6. Clarification of determination of foreign taxes deemed paid	DOE	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
7. Clarification of foreign tax credit limitation for financial services income	DOE	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
8. Interest on underpayment reduced by foreign tax credit carryback	ftpoa tyba DOE	---	8	10	2	1	1	1	1	1	1	1	22	27
9. Determination of period of limitations relating to foreign tax credits	ftpoa tyba DOE	---	1	2	1	1	1	1	1	1	1	1	6	11
SUBTOTAL OF FOREIGN SIMPLIFICATION AND OTHER FOREIGN-RELATED PROVISIONS		---	-11	4	-102	-175	-226	-307	-323	-358	-391	-425	-512	-2,318

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
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	1/1/98	---	-2	-38	-35	-35	-35	-35	-35	-38	-37	-36	-146	-327
2. Increase de minimis threshold for estimated tax to $1,000	tyba 12/31/97	---	-134	-17	-18	-19	-20	-21	-22	-24	-25	-26	-208	-326
3. Optional methods for computing SECA combined; increase dollar amount to provide four quarters of coverage [16]	tyba 12/31/97	---	1	1	1	2	2	2	2	2	2	2	8	16
4. Treatment of certain reimbursed expenses of rural mail carriers	tyba 12/31/97	---	[2]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
5. Treatment of travel expenses of certain Federal employees engaged in criminal investigations	eii tyea DOE	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-1	-2
6. Permit payment of taxes by any commercially acceptable means	DOE	Negligible Revenue Effect												
B. Provisions Relating to Businesses Generally														
1. Modify look-back method for long-term contracts	cci tyea DOE	---	-1	-2	-3	-4	-4	-4	-4	-5	-5	-5	-14	-37
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	-12	-27
3. Provide for exclusion for construction allowances provided to lessees	leia DOE	Negligible Revenue Effect												
C. Provisions Relating to Partnerships														
1. Simplified reporting to partners	tyba 12/31/97	---	6	8	8	8	8	9	9	9	9	9	38	83
2. Simplified audit procedure for large partnerships	tyba 12/31/97	---	[9]	[9]	[9]	1	1	1	1	1	1	1	2	8
3. Due date for furnishing information to partners of large partnerships	tyba 12/31/97	No Revenue Effect												
4. Returns required on magnetic media for partnerships with 100 partners or more	tyba 12/31/97	Negligible Revenue Effect												
5. Treatment for partnership items of individual retirement accounts	tyba 12/31/97	No Revenue Effect												
6. Other partnership audit rules	tyba 12/31/97	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-1	-3
7. Closing partnership taxable year with respect to deceased partner	tyba 12/31/97	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-1	-1
D. Provisions Relating to Real Estate Investment Trusts														
1. Clarification of limitation on maximum number of 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 retain capital gains	tyba DOE	Negligible Revenue Effect												
5. Repeal 30% gross income requirement	tyba DOE	---	-4	-5	-5	-6	-7	-7	-8	-9	-10	-11	-26	-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												

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
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. Provisions Relating to Regulated Investment Companies														
1. Repeal 30% gross income limitation for regulated investment companies	tyba 12/31/97	---	-12	-23	-27	-33	-38	-45	-53	-61	-71	-82	-134	-447
F. Taxpayer Protections														
1. Provide "reasonable cause" exception for 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 pass-through entities	tyba	No Revenue Effect												
5. Clarify procedure for administrative cost awards	aca DOE	No Revenue Effect												
6. Civil damages for unauthorized inspection of tax returns or tax return information; notification of unlawful inspection or disclosure	voo/a DOE	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]	[17]
SUBTOTAL OF SIMPLIFICATION PROVISIONS RELATING TO INDIVIDUALS AND BUSINESSES		[17]	-147	-79	-83	-90	-97	-104	-114	-129	-140	-152	-500	-1,146
XIII. SIMPLIFICATION PROVISIONS RELATING TO ESTATE AND GIFT TAXES														
1. Gifts to charities of over $10,000 exempt from gift tax filing requirements	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 rules under section 2056A	aiii OBRA'90	Negligible Revenue Effect												
4. Clarifications relating to certain disclaimers	Dma DOE	---	-4	-4	-4	-4	-4	-4	-5	-5	-5	-5	-20	-44
5. Increase of amount of lapse of general power of appointment not treated as release for purposes of estate and gift tax (5 or 5 power)	tyba DOE	---	---	-3	-3	-3	-3	-3	-3	-3	-3	-3	-12	-27
6. Estate and gift tax treatment of short-term OID instruments	dda DOE	Negligible Revenue Effect												
7. Certain revocable trusts treated as part of estate	dda DOE	---	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-15	-30
8. Distributions during first 65 days of taxable year of estate	dda DOE	Negligible Revenue Effect												
9. Separate share rules available to estates	dda DOE	Negligible Revenue Effect												
10. Executor of estate and beneficiaries treated as related persons for disallowance of losses	tyba DOE	Negligible Revenue Effect												
11. Limitation on taxable year of estates	dda DOE	Negligible Revenue Effect												

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Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
12. Treatment of funeral trusts	tyba DOE	---	2	2	2	2	2	2	2	2	2	2	10	20
13. Adjustments for certain gifts within 3 years of decedent's death	dda DOE							No Revenue Effect						
14. Clarification of treatment of survivor annuities under qualified terminable interest rules	dda DOE							Negligible Revenue Effect						
15. Treatment under qualified domestic trust rules of forms of ownership which are not trusts	dda DOE							Negligible Revenue Effect						
16. Opportunity to correct certain failures under section 2032A	DOE							Negligible Revenue Effect						
17. Authority to waive requirement of United States trustee for qualified domestic trusts	dda DOE							No Revenue Effect						
SUBTOTAL OF SIMPLIFICATION PROVISIONS RELATING TO ESTATE AND GIFT TAXES		—	-5	-8	-8	-8	-8	-8	-9	-9	-9	-9	-37	-81
XIV. SIMPLIFICATION PROVISIONS RELATING TO EXCISE TAXES, TAX EXEMPT BONDS, AND OTHER MATTERS														
A. Excise Tax Simplification														
1. Increase de minimis limit for after-market alterations for heavy truck and luxury car excises	DOE							Negligible Revenue Effect						
2. Credit or refund for imported bottled distilled spirits returned to distilled spirits plant	fcq DOE + 90 days							Negligible Revenue Effect						
3. Authority to cancel or credit export bonds without submission of records	fcq DOE + 90 days							No Revenue Effect						
4. Repeal of required maintenance of records on premises of distilled spirits plant	fcq DOE + 90 days							No Revenue Effect						
5. Fermented material from any brewery may be received at a distilled spirits plant	fcq DOE + 90 days							Negligible Revenue Effect						
6. Repeal of requirement for wholesale dealers in liquors to post sign	DOE							No Revenue Effect						
7. Refund of tax to wine returned to bond not limited to unmerchantable wine	fcq DOE + 90 days							Negligible Revenue Effect						
8. Use of additional ameliorating material in certain wines	fcq DOE + 90 days							No Revenue Effect						
9. Domestically produced beer may be withdrawn free of tax for use of foreign embassies, legations, etc	fcq DOE + 90 days							Negligible Revenue Effect						
10. Beer may be withdrawn free of tax for destruction	fcq DOE + 90 days							Negligible Revenue Effect						
11. Authority to allow drawback on exported beer without submission of records	fcq DOE + 90 days							No Revenue Effect						
12. Imported beer or wine transferred in bulk to brewery or winery without payment of tax	fcq DOE + 90 days							Negligible Revenue Effect						
13. Authority for IRS to grant exemption from excise tax registration requirements	DOE							No Revenue Effect						
14. Repeal of excise tax "deadwood" provisions (including ozone depleting)	DOE							No Revenue Effect						

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-02	1997-07
15. Replace truck excise tax deduction for tire value with tax credit for excise tax paid on tires.... ..	1/1/98	---	66	94	96	97	99	101	102	105	108	110	452	979
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	---	[2]	-2	-3	-5	-6	-8	-9	-10	-11	-12	-17	-65
2. Exclusion from arbitrage rebate for earnings on bona fide debt service fund under construction bond rules..	bia DOE	---	[2]	-1	-2	-3	-3	-4	-5	-6	-6	-7	-9	-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..	DOE	No Revenue Effect												
C. Administrative Provisions														
1. Clarify jurisdiction of Tax Court with respect to overpayment determinations......................................	DOE	---	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-15	-30
2. Clarify Tax Court jurisdiction over interest determinations..	DOE	No Revenue Effect												
3. Clarify net worth requirements for awards of administrative or litigation costs..............................	DOE	No Revenue Effect												
4. Clarify Tax Court jurisdiction for independent contractors...	DOE	Negligible Revenue Effect												
D. Other Provisions														
1. Extend due date for first quarter estimated tax by private foundations..	tyba DOE	---	-2	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	-2	-3
2. Clarification of authority to withhold Puerto Rico income taxes from salaries of Federal employees...	1/1/98	---	-2	-3	-1	-1	-1	-1	-1	-1	-1	-1	-8	-13
3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments..	1/1/98	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-10
4. Oklahoma technical on Indian wage credits and development incentives for property with 10-year lives or less..	dwcorfpt 3/18/97	---	-145	-30	8	27	23	20	20	19	18	16	-117	-24
SUBTOTAL OF SIMPLIFICATION PROVISIONS RELATING TO EXCISE TAXES, TAX EXEMPT BONDS, AND OTHER MATTERS..		—	-87	54	94	111	108	104	103	103	104	102	279	797
XV. TECHNICAL CORRECTIONS...	—	—	—	—	—	—	—	—	—	—	—	—	—	—
XVI. INCREASE IN PUBLIC DEBT LIMIT................................	—	—	—	—	—	—	—	—	—	—	—	—	—	—
NET TOTAL..		7	7,102	-17,134	-26,629	-27,860	-20,349	-26,598	-29,255	-31,494	-35,671	-40,445	-84,663	-248,133

Source: Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Assumed enactment date of 10/1/97.

[Legend and Footnotes for Table #97-1 149 appear on the following page]

Legend and Footnotes for Table #97-1 149:

Legend for "Effective" column:

aca = actions commenced after
aiiia = amounts includible in income after
aiii OBRA'90 = as if included in the Omnibus Budget Reconciliation Act of 1990
aiii SBJPA = as if included in the Small Business Job Protection Act of 1996
aoty = all open taxable years
bia = bonds issued after
cci = contracts completed in
cfa = claims filed after
cia = contracts issued after
cseia = constructive sales entered into after
da = distributions after
da/a = distributions and acquisitions after
dda = decedents dying after
Dma = disclaimers made after
dma = disclosures made after
DOE = date of enactment
dofca = date of first committee action
dpoaa = dividends paid or accrued after
droaa = dividends received or accrued after

dwcorfpt = depreciation and wages claimed on returns filed prior to
eii = expenses incurred in
fcq DOE + 90 days = first day of the calendar quarter that begins at least 90 days after date of enactment
ftpoa = foreign taxes paid or accrued in
gma = gifts made after
gra = gross receipts after
gsta = generation skipping transfers after
icoa = involuntary conversions occurring after
iia = instruments issued after
leia = leases entered into after
lia = levies issued after
NOLgi = net operating losses generated in
oaa = obligations acquired after
pa = payments after
pca = proceedings commenced after
pcpa = property contributed to partnership after
pda = partnership distributions after
pma = payments made after
ppisa = property placed in service after

pra = payments received after
rd = returns due
rda = returns due after
rfa = returns filed after
roa = rentals occurring after (for returns open on date of first committee action)
sa = severances after
sea = sales or exchanges after
sepda = sales and exchanges, and certain partnership distributions after
spi = services performed in
ta = transactions after
Ta = transfers after
tyba = taxable years beginning after
tyea = tax years ending after
tybo/a = taxable years beginning on or after
tsoaiTg = tax shelters offered after issuance of Treasury guidance
voo/a = violations occurring on or after
wpoifhma = wages paid or incurred for hires made after
30da = 30 days after
90da = 90 days after

[1] Considers interaction with HOPE tax credit proposal.

[2] Loss of less than $500,000.

[3] Considers interaction with AD IRA proposal.

[4] Negligible revenue effect.

[5] Loss of less than $5 million.

[6] Revenue estimate includes interactions with other educational savings provisions.

[7] Estimate includes interaction with welfare-to-work tax credit.

[8] All D.C. tax initiatives are contingent on the creation of an Economic Development Corporation in 1997; estimate assumes creation of such an economic development corporation and enactment of reforms to D.C. borrowing authority similar to that in the Administration's package.

[9] Gain of less than $500,000.

[10] Loss of less than $1 million.

[11] Considers interaction with proposal to allow bakery drivers to be treated as independent contractor for employment tax purposes.

[12] Estimate provided by the Congressional Budget Office.

[13] Assumes prior or concurrent passage of legislation to allow Virgin Island financing on parity basis.

[14] This proposal may also have outlay effects through interaction with Federal farm programs.

[15] Provision would be effective for taxable years ending after the date of first committee action, for new suspense accounts, and taxable years beginning after that date for existing accounts. Balances in new accounts would be 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 would not exceed 50% of the taxable income of the taxpayer before the inclusion.

[16] Proposal may have outlay effects.

[17] Gain of less than $1 million.

B. BUDGET AUTHORITY AND TAX EXPENDITURES

Budget authority

In compliance with subdivision (B) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the revenue reconciliation provisions involve no new or increased budget authority. The earned income compliance provisions (sec. 1067) will reduce outlays (and budget authority). (See the revenue table in Part IV.A., above).

Tax expenditures

In compliance with subdivision (B) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions relative to income tax reductions generally involve increased tax expenditures and that the provisions relating to increased income tax revenues generally involve reduced tax expenditures (see revenue table, above). Non-income tax provisions are not classified as tax expenditures under the Budget Act. Also, certain compliance simplification provisions and technical corrections provisions do not involve tax expenditures.

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with subdivision (c) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, requiring a cost estimate prepared by the Congressional Budget Office (CBO), the following statement by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 16, 1997.

Hon. BILL ARCHER,
Chairman, Committee on Ways and Means
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for the revenue reconciliation recommendations of the House Committee on Ways and Means.

The estimate shows the budgetary effects of the committee's proposals over the 1998–2002 period, and attached tables show the effects through 2007. CBO understands that the Committee on the Budget will be responsible for interpreting how these proposals compare with the reconciliation instructions in the budget resolution.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Stephanie Weiner.

Sincerely,

PAUL VAN DE WATER
(For June E. O'Neill, Director).

Enclosure.

Revenue reconciliation recommendations of the House Committee on Ways and Means

Summary: The revenue reconciliation provisions recommended by the Committee on Ways and Means would make many changes to the Internal Revenue Code. A new credit for children under age 17 would result in the largest reduction in revenue. Other major reductions in revenue would result from a new tax credit for students, back-loaded IRAs, educational investment accounts, and modifications to the alternative minimum tax and to the estate and gift tax. Lower taxation of capital gains realizations would raise revenue in the first five years but lose revenue over the first ten years. The provisions also include changes that would generate revenue—about three-quarters of the extra revenue would come from extending and modifying aviation excise taxes.

Estimated cost to the Federal Government: The Joint Committee on Taxation (JCT) provided estimates for most of the revenue reconciliation provisions, and CBO concurs with their estimates. CBO and JCT estimate that these provisions, including Earned Income Credit (EIC) compliance proposals, would reduce governmental receipts by $84.653 billion over the 1997–2002 period. The EIC provisions also would reduce outlays by about $0.078 billion over the five year period. In addition CBO estimates that the provision to phase out the ethanol tax credit would increase Commodity Credit Corporation outlays by about $0.051 billion over the 1998–2002 period. Please refer to the enclosed CBO and JCT tables for a more detailed estimate of the provisions.

ESTIMATED BUDGETARY IMPACT OF THE REVENUE RECONCILIATION RECOMMENDATIONS OF THE HOUSE COMMITTEE ON WAYS AND MEANS

	By fiscal year in billions of dollars—					
	1997	1998	1999	2000	2001	2002
REVENUES						
Projected Revenues Under Current Law[1] ..	1,554.894	1,609.184	1,675.264	1,750.097	1,827.964	1,910.260
Proposed Changes:[2]						
On Budget	0.007	7.218	−17.084	−26.586	−27.623	−20.320
Off Budget[3]	0.000	−0.116	−0.048	−0.040	−0.034	−0.026
Projected Revenues Under the Recommendations	1,554.901	1,616.288	1,658.133	1,723.471	1,800.301	1,889.914
OUTLAYS						
Projected Commodity Credit Corporation Outlays Under Current Law	5.331	7,093	6.830	6.298	5.140	4.826
Proposed Changes	([4])	([4])	([4])	([4])	0.002	0.049
Projected Commodity Credit Corporation Outlay Under the Recommendations	5.331	7.093	6.830	6.298	5.142	4.875
Projected EIC Outlays[1] Under Current Law	20.822	21.685	22.495	23.333	23.965	24.732
Proposed Changes	([4])	−0.016	−0.022	−0.021	−0.019	−0.019
Projected EIC Outlays Under the Recommendations	20.822	21.669	22.473	23.312	23.946	24.713

[1] Projections consistent with the FY 1998 Budget Resolution.

[2] Includes the revenue effect of EIC compliance proposals.

[3] The following five provisions would affect social security revenues, which are off budget: employer provided education assistance, phase out the exclusion for qualified tuition reduction, independent contract for bakery drivers, safe harbor for independent contractors, and optional methods for computing SECA combined.

[4] Less than $500,000.

The outlay effects of this legislation fall within budget functions 350 (agriculture) and 600 (income security)

Intergovernmental and private-sector impact: In accordance with the requirements of Public Law 104–4, the Unfunded Mandates Reform Act of 1995, JCT has determined that the bill contains several private sector mandates. Please refer to the enclosed letter for a more detailed account of these provisions. These provisions would impose direct cost on the private sector of more than $100 million in each year from 1996–2000. The JCT estimates the direct mandate cost of tax increases in the bill would total $8,990 billion in 1998, and $47.064 billion over the 1998–2002 period, as shown below:

ESTIMATED FEDERAL PRIVATE SECTOR MANDATE IMPACT OF THE REVENUE RECONCILIATION RECOMMENDATIONS OF THE HOUSE COMMITTEE ON WAYS AND MEANS

	By fiscal years, in billions of dollars—				
	1998	1999	2000	2001	2002
Private Sector Mandates	8.990	8.302	9.095	9.994	10.683

In addition, JCT has determined that the provision to extend and modify the Airport and Airway Trust Fund excise taxes and the provision to modify the vaccine excise tax may impose an intergovernmental mandate on State, local, and tribal governments. JCT estimates that the direct cost of complying with these intergovernmental mandates will not exceed $50 million in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year.

Estimate prepared by: Stephanie Weiner (226–2720).

Estimate approved by: Rick Kasten, Deputy Assistant Director for Tax Analysis.

ESTIMATED BUDGETARY EFFECTS OF THE REVENUE RECONCILIATION RECOMMENDATIONS OF THE HOUSE COMMITTEE ON WAYS AND MEANS

[In billions of dollars, by fiscal years]

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998–2007 total
				CHANGES IN REVENUES							
On Budget Revenues [1]	7.218	−17.084	−26.586	−27.623	−20.320	−26.575	−29.231	−31.470	−35.647	−40.421	−247.739
Off Budget Revenues	−0.116	−0.048	−0.040	−0.034	−0.026	−0.020	−0.021	−0.021	−0.021	−0.021	−0.368
Total	7.102	−17.132	−26.626	−27.657	−20.346	−26.595	−29.252	−31.491	−35.668	−40.442	−248.107
				CHANGES IN DIRECT SPENDING							
Commodity Credit Corporation Outlays	([2])	([2])	([2])	0.002	0.049	0.059	0.045	0.032	0.022	0.018	0.227
Earned Income Credit Outlays	([2])	−0.016	−0.022	−0.021	−0.019	−0.019	−0.019	−0.018	−0.018	−0.018	−0.170
Total	([2])	−0.016	−0.022	−0.019	0.030	0.040	0.026	0.014	0.004	0.000	0.057

[1] Includes the revenue effects of the Earned Income Credit compliance proposals.

[2] Less than $500,000.

COMMITTEE ON WAYS AND MEANS ESTIMATED BUDGET EFFECTS OF CHAIRMAN'S MARK RELATING TO EARNED INCOME CREDIT COMPLIANCE PROPOSALS; FISCAL YEARS 1998–2007

[In millions of dollars]

Provision	Effective	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998–02	1998–07
Earned Income Credit Compliance (''EIC'') Proposals: (a) deny eligibility for prior acts of recklessness; (b) recertification required when EIC denied in past; and (c) due diligence requirement for paid preparers.	tyba 12/31/96	[1] 9	18	25	24	21	21	21	21	21	21	88	88

[1] Gains of less than $500,000.

Note. Details may not add to totals due to rounding.

Legend for ''Effective'' column: tyba=taxable years beginning after.

Source: Joint Committee on Taxation.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, DC, June 14, 1997.

Mrs. JUNE O'NEILL,
Director, Congressional Budget Office, U.S. Congress, Washington, DC.

DEAR MRS. O'NEILL: The Staff of the Joint Committee on Taxation has reviewed the revenue reconciliation provisions ordered to be reported by the House Committee on Ways and Means on June 14, 1997. In accordance with requirements of Public Law 104–4, the Unfunded Mandates Reform Act of 1995 (the "Unfunded Mandates Act"), we have determined that the following provisions contain Federal private sector mandates:

Phase out the exclusion for qualified tuition reduction (sec. 117(d));

Modify excise tax on imported halons;

Constructive sales treatment for appreciated financial positions;

Disallowance of interest on indebtedness allocable to tax-exempt obligations;

Gains or losses from certain terminations with respect to property;

Determination of original issue discount where pooled debt obligations subject to acceleration;

Tax treatment of extraordinary dividends;

Recognition of gain in certain section 355 transactions;

Tax treatment of redemptions involving related corporations;

Modify holding period for dividends received deduction;

Registration and other provisions relating to confidential corporate tax shelters;

Certain preferred stock treated as "boot";

Reporting of certain payments made to attorneys;

Consistency requirement for returns of beneficiaries of estates and trusts;

Extend and modify Airport and Airway Trust Fund excise taxes;

Tax kerosene in the same manner as diesel fuel;

Reduce ethanol tax credit and excise tax exemptions;

Modify control test and include attribution rules to determine UBIT consequences of certain payments from subsidiaries to tax-exempt organizations;

Carryover basis on sale of property by tax-exempt related party;

Extend reporting and proxy tax requirements for political and lobbying expenditures to all section 501(c) organizations except charitable organizations;

Repeal 1986 Act grandfather rules for pension business of certain insurers;

Termination of suspense accounts for family farm corporations;

2-year carryback and 20-year carryforward of net operating losses;

Modification of treatment of company-owned life insurance;

Modify the basis allocation rules for distributee partners;

Eliminate the substantial appreciation requirement for inventory of a partnership;

Extend the 5-year time limit for taxing pre-contribution gain to 10 years;

Restrict income forecast method;

Repeal 14-day rule on rental of vacation properties;

Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person;

Repeal installment sales grandfather rules of 1986 Act;

Inclusion of income from notional principal contracts and stock lending transactions under Subpart F;

Further restrict like-kind exchanges involving foreign personal property;

Impose holding period requirement for claiming foreign tax credits with respect to dividends;

Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons;

Limitation on treaty benefits for payments to hybrid entities;

Interest on underpayment reduced by foreign tax credit carryback;

Determination of period of limitations relating to foreign tax credits;

Optional methods for computing SECA combined;

Simplified reporting for partners of partnerships;

Simplified audit procedure for large partnerships;

Treatment of funeral trusts;

Replace truck excise tax deduction for tire value with tax credit for excise tax paid on tires;

Reinstate LUST excise tax and extend through 9/30/02;

Modify vaccine excise tax;

Impose telephone excise tax on prepaid telephone cards; and

Earned income credit compliance provisions.

The attached revenue table (items highlighted in bold) generally reflects amounts that are no greater than the aggregate estimated amounts that the private sector will be required to spend in order to comply with these Federal private sector mandates.

There are two provisions that may impose a Federal intergovernmental mandate on State, local, and tribal governments. These provisions are the following:

Extend and modify the Airport and Airway Trust Fund excise taxes; and

Modify vaccine excise tax.

The staff of the Joint Committee on Taxation estimates that the direct costs of complying with these Federal intergovernmental mandates will not exceed $50,000,000 in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year.

If you would like to discuss this information in further detail, please feel free to contact me. Thank you for your cooperation in this matter.

Sincerely,

KENNETH J. KIES.
Chief of Staff.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. COMMITTEE OVERSIGHT FINDINGS AND RECOMMENDATIONS

With respect to subdivision (A) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was the result of the Committee's oversight review concerning tax burdens of families, expanded educational tax benefits, savings and investment incentives, estate and gift tax burdens on families and closely-held businesses, extension of certain expiring tax provisions, District of Columbia tax incentives, welfare-to-work tax credit, various miscellaneous tax provisions, revenue-offset provisions (including a 10-year extension of financing of the Airport and Airway Trust Fund and corporate and other tax reforms), numerous tax simplification provisions (most of which have been previously approved by the Committee and the Congress in the Balanced Budget Act of 1995 in the 104th Congress, but not enacted), needed technical corrections to recently-passed tax legislation, and an increase in the public debt limit as projected under the Balanced Budget Agreement and the Fiscal Year 1998 Budget Resolution, that the Committee concluded that it is appropriate and timely to enact the revenue reconciliation provisions included in the Committee's budget reconciliation recommendations.

B. SUMMARY OF FINDINGS AND RECOMMENDATIONS OF THE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

With respect to subdivision (D) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee advises that no oversight findings or recommendations have been submitted to the Committee by the Committee on Government Reform and Oversight.

C. CONSTITUTIONAL AUTHORITY STATEMENT

With respect to clause 2(l)(4) of rule XI of the Rules of the House of Representatives (relating to Constitutional authority), the Committee states that the Committee's action in reporting these revenue reconciliation provisions is derived from Article I of the Constitution, Section 7 ("All bills for raising revenue shall originate in the House of Representatives") and Section 8 ("The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts... of the United States"), and from the 16th Amendment to the Constitution.

D. INFORMATION RELATING TO UNFUNDED MANDATES

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector:

Phase out the exclusion for qualified tuition reduction (sec. 117(d));

Modify excise tax on imported halons;

Constructive sales treatment for appreciated financial positions;

Disallowance of interest on indebtedness allocable to tax-exempt obligations;

Gains or losses from certain terminations with respect to property;

Determination of original issue discount where pooled debt obligations subject to acceleration;

Tax treatment of extraordinary dividends;

Recognition of gain in certain section 355 transactions;

Tax treatment of redemptions involving related corporations;

Modify holding period for dividends received deduction;

Registration and other provisions relating to confidential corporate tax shelters;

Certain preferred stock treated as "boot";

Reporting of certain payments made to attorneys;

Consistency requirement for returns of beneficiaries of estates and trusts;

Extend and modify Airport and Airway Trust fund excise taxes;

Tax kerosene in the same manner as diesel fuel;

Reduce ethanol tax credit and excise tax exemptions;

Modify control test and include attribution rules to determine UBIT consequences of certain payments from subsidiaries to tax-exempt organizations;

Carryover basis on sale of property by tax-exempt related party;

Extend reporting and proxy tax requirements for political and lobbying expenditures to all section 501(c) organizations except charitable organizations;

Repeal 1986 Act grandfather rules for pension business of certain insurers;

Termination of suspense accounts for family farm corporations;

2-year carryback and 20-year carryforward of net operating losses;

Modification of treatment of company-owned life insurance;

Modify the basis allocation rules for distributee partners;

Eliminate the substantial appreciation requirement for inventory of a partnership;

Extend the 5-year time limit for taxing pre-contribution gain to 10 years;

Restrict income forecast method;

Repeal 14-day rule on rental of vacation properties;

Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person;

Repeal installment sales grandfather rules of 1986 Act;

Inclusion of income from notional principal contracts and stock lending transactions under Subpart F;

Further restrict like-kind exchanges involving foreign personal property;

Impose holding period requirement for claiming foreign tax credits with respect to dividends;

Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons;

Limitation on treaty benefits for payments to hybrid entities;

Interest on underpayment reduced by foreign tax credit carryback;

Determination of period of limitations relating to foreign tax credits;

Optional methods for computing SECA combined;

Simplified reporting for partners of partnerships;

Simplified audit procedure for large partnerships;

Treatment of funeral trusts;

Replace truck excise tax deduction for tire value with tax credit for excise tax paid on tires;

Reinstate LUST excise tax and extend through 9/30/02;

Modify vaccine excise tax;

Impose telephone excise tax on prepaid telephone cards; and

Earned income credit compliance provisions.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effects of the provision. Benefits from the provisions include improved administration of the Federal income tax laws and a more accurate measurement of income for Federal income tax purposes. In addition, the extension and modification of the Airport and Airway Trust Fund excise taxes are designed to fund Federal administration of the airways and other important air services. The Committee believes the benefits of the bill are greater than the costs required to comply with the Federal private sector mandates contained in the bill.

The revenue-raising provisions of the bill are used to offset partially the costs of a child credit for certain low- and middle-income taxpayers, tax incentives for higher education (including the Administration's HOPE credit), capital gains tax relief, reduced estate and gift taxes, alternative minimum tax relief, and other important tax incentives. These provisions are generally designed to ease the burdens of Federal income and estate taxation on individuals and small business and the revenue-raising provisions of the bill are critical to achieving these goals.

The provision to extend the Airport and Airway Trust Fund taxes, the provision relating to State and local tax refund offsets, and the modifications to the vaccine excise tax impose Federal intergovernmental mandates. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with these Federal intergovernmental mandates will not exceed $50,000,000 in either the first fiscal year or in any one of the 4 fiscal years following the first fiscal year. The Committee intends that the Federal intergovernmental mandates be unfunded because, in the case of the Airport and Airway Trust Fund taxes, the mandates fund the maintenance of U.S. airports and airways and the Committee believes that it is appropriate for State, local, and tribal governments to bear their allocable share of the responsibility for such funding. In the case of the vaccine excise tax, the Committee believes it appropriate for all purchasers of vaccines to pay the excise tax, which is used to compensate victims for injuries suffered from vaccines. In the case of the other Federal intergovernmental mandates, the Committee believes that these provisions are necessary to assure the effective administration of the Federal tax laws.

The revenue provisions of the bill generally affect activities that are only engaged in by the private sector. The provision extending the Airport and Airway Trust Fund excise taxes and the modifications to the vaccine excise tax are imposed both on the private sector and on State, local, and tribal governments and, thus, do not affect the competitive balance between such governments and the private sector.

E. APPLICABILITY OF HOUSE RULE XX15(C)

Rule XXI5(c) of the Rules of the House of Representatives provides that no bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase shall be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members voting. Rule XXI5(d) of the Rules of the House of Representatives prohibits retroactive Federal income tax rate increases. These rules apply only to existing specific statutory Federal income tax rates in section 1 (a)–(e), section 11(b) or section 55(b) of the Internal Revenue Code of 1986, or adding new income tax rates to the highest of such specific income tax rates. The Committee has carefully reviewed the provisions of the bill to determine whether any of these provisions constitute a Federal income tax rate increase within the meaning of the House rules. It is the opinion of the Committee that there is no provision in the bill that constitutes a Federal income tax rate increase within the meaning of House rule XXI5 (c) or (d).

MISCELLANEOUS HOUSE REPORT REQUIREMENTS

Congressional Budget Office Estimate

Section 403 of the Congressional Budget Act and clause 2(l)(3)(B) of rule XI require reports to include a timely submitted cost estimate by the Congressional Budget Office (CBO). CBO provided an estimate of the legislation submitted by the Committee on Ways and Means which is included under the appropriate title.

Constitutional Authority Statement

Clause 2(l)(4) of rule XI, as amended by section 13 of H. Res. 5, requires each committee report on a bill or joint resolution of a public character to include a statement citing the specific powers granted to the Congress by the Constitution to enact the proposed law. The Committee on the Budget states that its action in reporting this bill is derived from Article I of the Constitution, Section 5 (“Each House may determine the Rules of its Proceedings”) and Section 8 (“The Congress shall have the power to make all Laws which shall be necessary and proper . . .”).

Budget Committee Oversight Findings

Clause 2(l)(3)(A) of rule XI requires each committee report to contain oversight findings and recommendations required pursuant to clause (2)(b)(1) of rule X. The Committee on the Budget has examined its activities over the past year and has determined that there are no specific oversight findings on the text of the reported bill.

Oversight Findings and Recommendations of the Committee on Government Reform and Oversight

Clause 2(l)(3)(D) of rule XI requires each committee report to contain a summary of oversight findings and recommendations made by the Government Reform and Oversight Committee pursuant to clause 4(c)(2) of rule X, whenever such findings have been timely submitted. The Committee on the Budget has received no such findings or recommendations from the Committee on Government Reform and Oversight on the text of the reported bill.

Committee Votes

Clause 2(l)(2)(B) of rule XI requires each committee report to accompany any bill or resolution of a public character, ordered to include the total number of votes cast for and against on each rollcall vote on a motion to report and any amendment offered to the measure or matter, together with the names of those voting for and against.

On June 20, 1997, the committee met in open session, a quorum being present. The committee ordered reported the text of the Revenue Reconciliation Act of 1997 pursuant to the reconciliation instructions contained in the conference report on H.Con.Res. 84, the Concurrent Resolution on the Budget for Fiscal Year 1998.

The following votes were taken by the committee:

1. Mr. Hobson moved that the committee order reported with a favorable recommendation the text of the Revenue Reconciliation Act of 1997, pursuant to clause 1 of rule XX and authorize the chairman to offer a motion to go to conference. The motion was agreed to by a rollcall vote of 20 ayes and 12 noes.

	Aye	No	Pres		Aye	No	Pres
Mr. Kasich, Chairman	X			Mr. Spratt, Ranking		X	
Mr. Hobson	X			Mr. McDermott		X	
Mr. Shays	X			Mr. Mollohan			
Mr. Herger	X			Mr. Costello		X	
Mr. Bunning				Mrs. Mink		X	
Mr. Smith of Texas				Mr. Pomeroy			
Mr. Miller	X			Ms. Woolsey		X	
Mr. Franks	X			Ms. Roybal-Allard			
Mr. Smith of Michigan	X			Ms. Rivers		X	
Mr. Inglis				Mr. Doggett		X	
Ms. Molinari	X			Mr. Thompson			
Mr. Nussle		X		Mr. Cardin		X	
Mr. Hoekstra	X			Mr. Minge		X	
Mr. Shadegg	X			Mr. Baesler			
Mr. Radanovich	X			Mr. Bentsen		X	
Mr. Bass	X			Mr. Davis		X	
Mr. Neumann	X			Mr. Sherman			
Mr. Parker	X			Mr. Weygand			
Mr. Ehrlich	X			Mrs. Clayton			
Mr. Gutknecht	X						
Mr. Hilleary	X						
Ms. Granger	X						
Mr. Sununu	X						

	Aye	No	Pres		Aye	No	Pres
Mr. Pitts	X						

2. Mr. McDermott moved that the Committee on the Budget direct its Chairman to request, on behalf of the committee, that the rule for the floor consideration of the second (revenue) reconciliation bill make in order an amendment to insert correction of the marriage penalty and to strike tax provisions that explode in cost and to strike certain corporate tax cuts. The motion failed by a rollcall vote of 11 ayes and 21 noes.

	Aye	No	Pres		Aye	No	Pres
Mr. Kasich, Chairman		X		Mr. Spratt, Ranking	X		
Mr. Hobson		X		Mr. McDermott	X		
Mr. Shays		X		Mr. Mollohan			
Mr. Herger		X		Mr. Costello	X		
Mr. Bunning				Mrs. Mink	X		
Mr. Smith of Texas				Mr. Pomeroy			
Mr. Miller		X		Ms. Woolsey	X		
Mr. Franks		X		Ms. Roybal-Allard			
Mr. Smith of Michigan		X		Ms. Rivers	X		
Mr. Inglis				Mr. Doggett	X		
Ms. Molinari		X		Mr. Thompson			
Mr. Nussle		X		Mr. Cardin	X		
Mr. Hoekstra		X		Mr. Minge	X		
Mr. Shadegg		X		Mr. Baesler			
Mr. Radanovich		X		Mr. Bentsen	X		
Mr. Bass		X		Mr. Davis	X		
Mr. Neumann		X		Mr. Sherman			
Mr. Parker		X		Mr. Weygand			
Mr. Ehrlich		X		Mrs. Clayton			
Mr. Gutknecht		X					
Mr. Hilleary		X					
Ms. Granger		X					
Mr. Sununu		X					
Mr. Pitts		X					

3. Mr. Cardin moved that the Committee on the Budget direct its Chairman request, on behalf of the committee, that the rule for floor consideration of the second (revenue) reconciliation bill shall make in order an amendment to provide that the children's tax credit be available to families before any benefit for which the family is eligible under the Earned Income Tax Credit is calculated, and to provide that the dependent tax credit shall not cause any reduction in the children's tax credit. The motion failed by a rollcall vote of 11 ayes and 21 noes.

	Aye	No	Pres		Aye	No	Pres
Mr. Kasich, Chairman		X		Mr. Spratt, Ranking	X		
Mr. Hobson		X		Mr. McDermott	X		
Mr. Shays		X		Mr. Mollohan			
Mr. Herger		X		Mr. Costello	X		
Mr. Bunning				Mrs. Mink	X		
Mr. Smith of Texas				Mr. Pomeroy			
Mr. Miller		X		Ms. Woolsey	X		
Mr. Franks		X		Ms. Roybal-Allard			
Mr. Smith of Michigan		X		Ms. Rivers	X		
Mr. Inglis				Mr. Doggett	X		
Ms. Molinari		X		Mr. Thompson			
Mr. Nussle		X		Mr. Cardin	X		
Mr. Hoekstra		X		Mr. Minge	X		

	Aye	No	Pres		Aye	No	Pres
Mr. Shadegg		X		Mr. Baesler			
Mr. Radanovich		X		Mr. Bentsen	X		
Mr. Bass		X		Mr. Davis	X		
Mr. Neumann		X		Mr. Sherman			
Mr. Parker		X		Mr. Weygand			
Mr. Ehrlich		X		Mrs. Clayton			
Mr. Gutknecht		X					
Mr. Hilleary		X					
Ms. Granger		X					
Mr. Sununu		X					
Mr. Pitts		X					

4. Mr. Minge moved that the Committee on the Budget direct its Chairman to request, on behalf of the committee, that the rule for the floor consideration of the second (revenue) reconciliation bill permit a floor amendment offered by Mr. Minge, or his designee, regarding balanced budget enforcement procedures which apply to spending revenues. The motion failed by voice vote.

5. Mr. Minge moved that the Committee on the Budget direct its Chairman to request, on behalf of the committee, that the rule for the floor consideration of the second (revenue) reconciliation bill permit a floor amendment offered by Mr. Minge, or his designee, to strike Section 1043 reducing the ethanol tax credit and replace lost revenues through a one-year delay in the phase out of the alternative minimum tax applicable to business activities. The motion was withdrawn.

6. Mr. Davis moved that the Committee on the Budget direct its Chairman to request, on behalf of the committee, that the rule for the floor consideration of the second (revenue) reconciliation bill should make in order an amendment to replace the provisions in the bill providing tax relief for higher education expenses with the proposals initiated by President Clinton, as included in the Ways and Means Democrats' alternative. The motion failed by voice vote.

7. Mr. Spratt moved that the Committee on the Budget direct its Chairman to request, on behalf of the committee, that the rule for the floor consideration of the second (revenue) reconciliation bill strike the proposal providing special tariff and quota protection for products such as textiles, apparels, footwear, tuna, petroleum and petroleum products coming from the Caribbean Basin Initiative beneficiary nations. The motion failed by voice vote.

Changes in Existing Law

Clause 3 of rule XIII provides that reports include the text of statutes that are proposed to be repealed and a comparative print of that part of the bill proposed to be amended whenever the bill repeals or amends any statute. The required matter is included in the report language for the legislative recommendations submitted by the Committee on Ways and Means and reported to the House by the Committee on the Budget.

Unfunded Mandate Statement

Section 423 of the Congressional Budget and Impoundment Control Act of 1974 requires a statement of whether the provisions of the reported bill include unfunded mandates. The committee received a letter regarding unfunded mandates from the Director of the Congressional Budget Office. [See the Congressional Budget Office Cost Estimate.]

Views of the Members of Committees Submitting Reconciliation Recommendations

The views following are from members of committees that have submitted reconciliation recommendations pursuant to H. Con. Res. 84. Although not technically required under rule XI, these views include those submitted by the authorizing committees that submitted the reconciliation recommendations that comprise the text of the bill.

DISSENTING VIEWS OF THE DEMOCRATIC MEMBERS OF THE COMMITTEE ON WAYS AND MEANS

We are united in our opposition to the revenue reconciliation bill reported by the Committee. Our opposition is the result of both the substance of the bill reported by the Committee and the procedures used in developing that legislation.

The bill reported by the Committee early in the morning of Friday, June 13th had been assembled by the Chairman without meaningful consultation with the Administration or the Democratic Members of this Committee. That procedure clearly is inappropriate in the context of what has been described as a bipartisan budget agreement. The fact that there was significant opposition among the Republican Members of the Committee to several of the proposals contained in the Chairman's mark and that one Republican voted against the Committee bill indicates that the Democrats were not alone in having their views disregarded in the development of this legislation.

After many months of intense negotiations, the Clinton Administration and Congressional Leadership finally hammered out an outline of a Balanced Budget Agreement (Agreement) in early May. Included in the bipartisan Agreement was the decision that any tax bill reported by this Committee must meet three basic requirements: (1) net tax cuts would not exceed $85 billion over the next 5 years and $250 billion over the next 10 years; (2) the tax relief for postsecondary education would be roughly $35 billion over 5 years and would be consistent with the President's HOPE scholarship credit and tuition deduction proposals; and (3) the Committee would make every effort to include various other Presidential initiatives, including (a) a welfare-to-work tax credit, (b) capital gains relief for home sales, (c) expanded Enterprise Zones and Enterprise Communities, (d) tax relief for cleaning up old industrial sites, known as "Brownfields," (e) tax relief for exports of software, and (f) tax incentives to spur economic growth in the District of Columbia.

In 1993, President Clinton and the Democratic Congress passed a major deficit reduction plan without a single Republican vote. Today, America continues to enjoy the success of this bold move, the deficit is down from almost $300 billion in 1992 to less than $70 billion this year. The economy continues to boom. Gross Domestic Product (GDP) growth has been strong and steady for 6½ years, the second-longest recovery since World War II. It has been sustained by private sector demand, not by a growing government, as Republicans monotonously claim. The unemployment rate has fallen from 7½ percent in 1992 to below 5 percent in 1997, a 24-year low. Eleven million new jobs have been created. Interest rates and inflation are historically low and stable. The American people have regained a sense of confidence in the economy and in their country. We are proud of this success and want to ensure it continues. Consequently, we take seriously our responsibility to craft legislation that ensures all Americans will continue to benefit from our growing economy. We stand ready to craft bipartisan legislation to achieve this goal.

We are strongly committed to three fundamental principles which should underlie such a bipartisan effort. We stand firm in our belief that the Members of this Committee can faithfully execute the mandate set for us in the bipartisan Agreement only if any tax cut: (1) is fair to all working Americans, particularly to working families; (2) does not include ballooning revenue losses in the outyears; and (3) meets the goals set out by the negotiated budget agreement.

We are disappointed that this bill fails to meet these requirements. We believe our Democratic alternative does meet them.

We oppose the substance of the Republican Committee bill because it is not fair. Also, it has exploding outyear revenue costs that endanger the goal of reaching a balanced budget.

Developing tax legislation means making choices. At every opportunity the Republican majority chose to deny tax benefits to low- and moderate-income families in order to fund tax relief for already well-off taxpayers. The following are several examples of these choices.

Family Credit

The $500-per-child income tax credit for families has been a headline item on the Republican agenda since they assumed the majority in 1995.

The Republicans have long promised to deliver such a tax credit to America's working families. The Contract with America included one. The vetoed Balanced Budget Act of 1995 included one. But, neither of those versions was as disingenuous as the family credit included in this Republican reconciliation bill.

The family credit in this reconciliation bill will be denied to low- and moderate-income working families and will be reduced for many families who pay for day care and claim the dependent care tax credit.

The family credit in the original Contract with America was refundable to the extent of Social Security taxes paid. The family credit in this bill is not refundable at all.

The family credit in the vetoed Balanced Budget Act of 1995 was allowed to be taken on the tax return ("stacked") *before* the Earned Income Tax Credit (EITC). The family credit in this bill is stacked *after* the EITC.

The Republicans have had to make choices in this tax bill in order to conform to the constraints of the balanced budget agreement. We understand that, in the context of a bill to balance the budget, it may be necessary to restrict the family credit. It may be necessary to deny the credit to some families, depending on their circumstances and the other effects of the bill on them, and depending on the other constraints on the deficit-reducing bill. The choices that were made in the Republican bill reflect the hearts and minds of the choosers.

Let's look at how the Republicans on the Committee on Ways and Means have made the choices about which families they could afford to give the family credit and which families they feel must be denied the $500 credit.

Income Limits. The Republican family credit applies to those with incomes up to and well above $110,000. For example, a couple with 3 children under 17 will qualify for a $1,500 family credit. Even though the credit phases down beginning at $110,000 of income, this family will receive a portion of their $1,500 credit unless the family's income exceeds $160,000. This is an expensive proposition. It means that very, very few households will be denied the credit because their income is too high.

How have the Republicans chosen to pay for that?

Refundability and Stacking Order. The Republican credit is not refundable, not even against Social Security taxes for working families. That is, those whose incomes are low enough that they owe little or no income tax will not receive the credit even if they pay substantial Social Security taxes. They will receive little or no credit because their income tax is not large enough to absorb the credit for which they would otherwise be eligible.

Not only is the Republican credit not allowed to offset payroll taxes, but it must be taken on the tax return after the EITC. That is, a taxpayer would compute his tax before credits; then, he would take whatever EITC he was entitled to against that amount of tax; then, if he still had any positive tax liability left, he would take the family credit against that remaining tax. However, if he did not have any income tax liability, he would get no family credit.

Anyone familiar with the EITC will recognize this as a way to deny the family credit to millions of working families. The majority of the EITC — 85% — is refunded to taxpayers. Taxpayers with children at that income level — below $20,000 — have little income tax liability to offset, so most of their EITC is refunded to them. Stacking a nonrefundable credit *after* the EITC means these families will never be able to take it. Their income tax liability will be offset by their EITC before they can consider claiming any part of the family credit.

By making families take their EITC first and stacking the family credit after that, the Republicans have crafted a family credit which will never reach millions of lower-income working families.

In sum, the Republicans have decided that they can afford to give the family tax credit to those who make $110,000 or more, but they cannot afford to give it to families who make $30,000 or less. That's not the choice we would make.

Child Care Credit Offset. Another way that the Republican bill, as reported, cuts back on the family credit is to require a child care offset to the family credit, beginning in 2002. A family would have to subtract from its $500-per-child family credit one-half of any dependent care credit taken for child care expenses. For those who receive the maximum child care credit of $960, this means a reduction in the family credit of $480 — just about the same as one child's-worth of the family credit. It also means a more complicated tax return for millions of American families.

This is antagonistic to all families who pay for child care and take the dependent care credit— both two-earner families and single parents. Since the once-traditional family (husband in the labor force, wife at home) has dwindled to only 17 percent of all families in 1994, a significant number of families will be hurt by this back-door reduction of the family credit.

Of 25 million married couples with children in 1994, almost 16.6 million (two-thirds) of them are two-worker families. Another 6.8 million families are maintained by single parents, the majority by working single women. All of these 23 million families have child care needs and expenses.

About one-quarter of them — 6 million taxpayers — deal with their child care needs in ways that qualify them for the dependent care credit on their tax return. Most of them are middle-income families: 4.4 million of them have incomes between $20,000 and $75,000. They would not be able to take a full family credit under the Republican tax plan.

The median income of these families is $40,000. Do we really want to deny a portion of the family credit to middle-income families making $40,000 simply because they have also have child care expenses?

The Republicans, it seems, have chosen to give the family credit with one hand and take it away with the other.

The Ultimate Choice. The result of these Republican choices is that 8.8 million children in 5 million upper-income families will qualify for the family credit at the expense of 28 million children in 15 million lower-income and poor families, and 6 million working families will get significantly reduced family credits simply because they use child care and claim the child care credits.

The Republicans have made that trade-off in the context of a bill in which those same upper-income families may also enjoy the benefits of the capital gains tax cuts, the education credit and deductions, the deferral aspect (or, potentially, tax-free status) of backloaded IRAs, and the benefits of the estate tax relief.

The lower-income working families, on the other hand, will see their family credit diminished if they also have child care expenses, will not receive the HOPE scholarship as promised in the budget agreement, and will have been labeled as "welfare recipients" by a Republican majority intent on channeling tax relief to the most fortunate of Americans.

That is a trade-off that we Democrats are unwilling to make.

The Democratic Choice. The Democratic Alternative, offered as a substitute in the Committee on Ways and Means, would rectify the imbalances reflected in the Republican bill. It would allow the family credit to apply against the amount of Social Security taxes a family pays, stack the credit before the EITC, and reject the notion of a child care offset to the credit.

This would restore the family credit for 20 million children in working families with incomes below $30,000--95 percent of them with incomes below $20,000-- to the extent of their Social Security tax payments.

This would allow the 3 million families with almost 5 million children, who would be denied a family credit because it is stacked after the EITC in the Republican bill, to receive one. For almost all of these families, this would result in a larger EITC. All 3 million of those working families would be better off.

It would allow 6 million hard-working families the full value of their child care credit *and* their family credit.

In recognition of the importance of deficit reduction and the constraints of the balanced budget agreement, it would make the family credit unavailable for those families with incomes above $75,000. The Democratic Alternative adopted the same income range for phasing the credit down that the President used in his family credit: $60,000 - $75,000. Families with income above $75,000 represent the top 15 percent of all families with children and are better able to afford the everyday expenses of child-rearing, without the help of the Federal Government, than are those at the bottom of the income scale.

The Democratic Alternative reflects the view that middle-income working families deserve a break. This tax bill should not benefit just (or primarily) those who are already doing very well in this country. The Democratic Alternative would spend more of the allotted tax cut on middle-income working families who deserve some help as they try to raise and educate their children.

The Democratic Alternative would cost exactly the same amount as the Republican family credit -- $71 billion -- but it would result in many more families and children receiving the credit. It would even provide the credit for children -- through age 17 -- one year older than under the Republican bill. In total, the Democratic plan would provide a credit for 60 million children compared to 39 million under the Republican plan.

The Democratic Alternative was rejected by all 22 Republicans on the Committee.

Education

One of the most important elements of the Agreement, as negotiated by the Republican Leadership, is that there would be roughly $35 billion in tax incentives for postsecondary education over five years. Speaker Gingrich and Senate Majority Leader Lott sent a letter to President Clinton describing the Bipartisan Budget Agreement, in which they stated:

> "specifically, it was agreed that the package must include tax relief of roughly $35 billion over five years for postsecondary education, including a deduction and tax credit. We believe this package should be consistent with the objectives put forward in the HOPE scholarship and tuition tax proposals contained in the Administration's fiscal year 1998 budget to assist middle-class parents." [Emphasis added]

The President has made it clear that he believes the Republicans' reconciliation package falls short of the agreement both in size and substance. Again, the choices made by the Republican bill deny benefits to moderate-income taxpayers in order to benefit the well-to-do.

The President proposed a HOPE scholarship for the first two years of college of up to $1,500 and a deduction of qualified education expenses of up to $10,000 for the second two years of college (with a choice of HOPE credit or deduction during the first two years). The credit and deduction would have been phased out for joint incomes of $80,000-$100,000; and single incomes of $50,000 - $75,000. These proposals were estimated to benefit more than 12 million students. Many of the students who would have benefitted from the President's plan are either currently in college, or are expected to enter college in the next few years.

The Republican committee bill makes several changes to the education tax incentives recommended by the President. Again, each of these changes has the effect of denying benefits to low- and -moderate income families while enhancing the benefits provided to higher income families.

Community Colleges — By allowing only a 50 percent HOPE credit, the Republican bill reduces the amount of the HOPE credit for students attending low-cost institutions like community colleges, the very institutions that many lower-income students attend. Under the Republican bill, a mere $22 billion would be allocated to the shrunken HOPE credit.

No deduction for average families — The Republican committee bill does not include the deduction for tuition costs recommended by the President. It substitutes a provision that permits a deduction only for tuition costs paid out of the investment earnings from a specified investment account. To be eligible for the maximum deduction under the Committee bill, the family must have $40,000 in accumulated investment earnings in that account. Few families will qualify for this maximum deduction, but those who do qualify will receive tax benefits larger than the maximum Pell grant provided to the poorest students in our society. There would be no deduction available to families struggling to pay tuition costs out of their wage income or from borrowed amounts. These choices will deny education assistance to many struggling middle-income families.

The Democratic Choice — Again the Democratic alternative takes a different approach. We would modify the President's education benefits in a fashion that would make them more available to those who need assistance. For the first two years of a student's postsecondary education, the Democratic HOPE scholarship would equal 100% of tuition costs. The limitation on the credit would phase up to $1,500 by the year 2000. For the remainder of a student's postsecondary education, the Democratic HOPE scholarship credit would equal 20% of tuition costs. The limitation on qualified costs against which the 20% credit would be computed would phase up to $10,000 by the year 2002, and the credit would reach $2,000. The Democratic HOPE credit would be phased out for joint returns between $80,000 and $100,000 of adjusted gross income and for single returns between $50,000 and $70,000 of adjusted gross income.

Also, the Democratic alternative recognizes that providing financial assistance to students qualified to attend college is not sufficient. We must take steps to ensure that more of our students are qualified to meet the rigors of college education. Therefore the Democratic substitute includes provisions designed to improve education provided at the primary and secondary level.

In addition to providing a broad alternative, Democrats on the Committee tried to amend these education incentives to provide fairness and to meet the promise of the negotiated budget agreement. Congressman Rangel, the Ranking Democrat on the Committee, offered an amendment to strike the Republican education provisions and substitute the $40 billion in postsecondary education incentives included in our Alternative package. However, Republicans rejected our attempt to bring the bill in line with the terms of the Agreement. We were unable to secure a single Republican vote on this amendment.

We believe that an important element of fairness is to provide the benefit first to those who need it most. We are disappointed that our Republican colleagues did not choose to help families with moderate incomes.

Capital Gains

Another area where the Republicans' choices made in this tax bill are objectionable to us is in the area of capital gains. The Republican bill contains very broad, very generous tax cuts for holders of capital assets. The tax cuts take the form of lower tax rates for assets purchased after May 7, 1997 and indexing for inflation beginning in 2001. This treatment is especially favorable for taxpayers who hold a considerable volume of capital gains and who engage in capital transactions frequently. The Republican bill skews the benefits toward the very wealthy and away from fairness and the middle-class.

The Republicans will defend their capital gains tax cut as benefitting the middle class because most taxpayers who report a capital gain on their tax returns are those with middle-range incomes. That argument is a smokescreen. While it is true that most who report capital gains are middle-income taxpayers, it is irrelevant to the question of who benefits from this tax bill. It is irrelevant because those middle-income taxpayers are realizing small amounts of capital gains. There just are many people in the "middle." Only about 15 percent of taxpayers with $30,000-$40,000 in income realize capital gains in any given year, and their gains average only $2,850. In contrast, 80 percent of those with incomes of $200,000 or more realize capital gains in any given year, and their gains average $144,000.

A recent study by the Congressional Budget Office documents the fact that most dollars of capital gains are held and realized by the very wealthy. Although nearly two-thirds of all *tax returns* reporting a capital gain are filed by taxpayers with incomes of $50,000 or less, more than 75 percent of all *dollars of capital gains* are realized by those with incomes of $100,000 or more. These taxpayers are the top 5 percent of the population. Many of them are very wealthy.

The Republicans will counter this by saying that the people who realize capital gains are not as wealthy as they appear; that they are classified as wealthy in the year they report a capital gain simply because of the gain itself. The Republicans' counterargument is false. This can be shown by looking at taxpayer returns over a several-year period. Again, the CBO study provides an answer. When taxpayers are tracked over time, the results remain the same: 70 percent of all capital gains realized over a 7-year period belonged to those with incomes of $100,000 or more.

Obviously, the more one realizes capital gains, the more one will benefit from a capital gains tax cut. The frequency with which high-income taxpayers realize capital gains also lends evidence to the conclusion that they will be the prime beneficiaries of this tax cut, not the middle class. Those in the highest income bracket realize capital gains in 7 out of 10 years, compared to an average of 4 out 10 years for all taxpayers who have capital gains and less often for those with incomes under $50,000.

The Republicans could have chosen to target capital gains relief to small business people, to farmers, to landholders. They could have chosen to be straightforward about whom they intend to help. Instead they have chosen to include in this bill provisions that will benefit the wealthy holder of financial assets, while describing it as a tax break for the middle-class. In addition to making the unfair choice on capital gains, the

Republicans are hiding behind the very people on whom they chose not to focus their capital gains relief.

The Democratic Choice. The Democratic Alternative did choose the small business person, the farmer, the taxpayer who makes capital transactions infrequently. Our plan would have allowed an 18-percent rate on gains up to a lifetime maximum amount of $600,000 per taxpayer for business assets (but not for stocks and bonds). We decided to spend our scarce dollars in this budget-balancing bill on the businessman selling his "sweat equity" life-long business in anticipation of retirement, on the family that must break up and sell the family farm, on taxpayers who have spent a lifetime building up productive, economically sound business assets, not on taxpayers who routinely profit by dialing their stock broker on the telephone.

We believe our version is more fair and rewards the time-honored American virtues of hard work, family tradition, and fair play.

Worker Classification Protection

Another choice the Republicans have made about which we have great concern is the provision that would permit employers to classify workers as independent contractors. While we respect the need to have the flexibility in our tax laws to accommodate the varied approaches to conducting business in today's economy, we must seek a balance that protects the millions of workers who are employees.

The provision contained in the bill is substantially similar to H.R. 1972, introduced in the last Congress. This legislation was the subject of an extensive hearing in the Oversight Subcommittee of the Committee on Ways and Means. During the hearing, witnesses uniformly raised serious issues and concerns regarding the impact of the legislation on workers. In a report on the issue of worker classification presented at the hearing, the New York State Bar concluded that H.R. 1972 (and similar proposals)

> "contain such easily satisfied objective criteria that there is a significant risk of undermining treatment of workers as employees, especially given the current cost incentives to employers to reclassify their workers as independent contractors." [Emphasis added].

This bill will allow employers to reclassify large groups of employees as independent contractors without any restructuring of the employment relationship. The potential for abuse in this area is very real. Last year, for example, the Department of Labor found that 134 workers in Ohio were improperly classified as independent contractors and were receiving as little as $1.50 per hour in compensation.

Most importantly, the classification of a worker as an independent contractor carries significant consequences: the worker does not receive employer-provided benefits such as pensions, health insurance coverage, paid vacation leave, paid sick leave, and other fringe benefits; the worker is not eligible for unemployment compensation or worker's compensation; the worker generally is not eligible for minimum wage and overtime protections; and the worker generally is not eligible to participate in collective bargaining. In addition, although the Republican bill purports to be limited to classification for tax purposes, it is highly likely that employers will also treat these workers as independent contractors for other purposes. Worker compensation laws, minimum wage and hour laws, occupational safety laws, and age discrimination laws do not apply in the case of workers classified as independent contractors.

Because these benefits form the bedrock of protection for America's workers, we must ensure that any changes in this area are carefully and fairly made. The Republicans have chosen to include a provision in the bill that fails this standard. It removes any safety net for workers. If enacted, the provision could result in detrimental changes in our labor force, the effects of which we may never correct.

Overall Distribution of Benefits

According to the Department of the Treasury, the tax cuts contained in this bill, when fully implemented, would disproportionately benefit the wealthiest taxpayers. Sixty-eight percent of the tax cuts would benefit the 20 percent of taxpayers with the highest incomes. The remaining 32 percent of the tax cuts would be spread among the remaining 80 percent of Americans.

Our Democratic alternative would do just the opposite, ensuring a fairer and more equitable distribution of the tax cuts. It would allocate 32 percent of the tax cuts to the top 20 percent and distribute 68 percent of the tax cuts to the remaining 80 percent of Americans. We are disheartened that our Republican colleagues did not support our efforts to modify the bill to ensure a fairer and more equitable distribution of the tax benefits.

Deficit Explosion in the Outyears

One of the fundamental principles of the Agreement is that any tax cut must be designed to ensure real and continued deficit reduction, even beyond the 10-year budget window. In a letter to the President's chief of staff, which concerned the desirability of cooperation and consultation between Congressional and Treasury Department revenue estimating staffs during this process, the Republican Leadership acknowledged the importance of real and continued deficit reduction beyond the budget period by stating: "The [negotiated balanced budget] proposal shall not cause costs to explode in the outyears."

By setting the stage for an explosion of revenue costs beyond the 10-year budget period, the Republicans have chosen to violate the fundamental terms of the Agreement and discredit the entire effort of providing tax cuts within the context of a balanced budget.

Both backloaded IRAs and capital gains indexing are ticking time bombs waiting to explode in cost, and will blow away the fiscal progress we have made over the last 4 years. These provisions have been cleverly designed to accelerate the receipt of revenue or delay the realization of costs, thus minimizing the true impact over the long-term. We cannot condone this fraud on the American people. They have entrusted us with this important task; we cannot let them down.

The array of tax cuts contained in this Republican bill are designed to keep their costs artificially low in the initial five- and ten-year periods. However, the costs of these tax cuts grow more rapidly outside the budget window, causing a massive explosion of the deficit in the second 10-year period. Estimates by the Joint Committee on Taxation of the year-by-year costs in the first 10-year period coupled with outside analyses suggest that this tax bill will lose $600 to $700 billion in forgone revenue in the second 10-year period.

We cannot support the deficit-exploding tax cuts in this legislation at the expense of our children and grandchildren. These tax cuts will do nothing more than saddle our younger generation with a deficit so large they may never escape it. Our concern regarding the exploding deficit under this bill was a driving force behind our efforts to provide a more fiscally responsible package. Congressman Rangel offered the Democratic Alternative as a substitute that would have accomplished this goal. This Democratic Alternative honors both the spirit and substance of the Agreement. There are no revenue gimmicks, no camouflage, no numbers games. This amendment was rejected by every Republican. The amendment failed, as the Republican bill fails the American people.

Other Choices

Empowerment Zones and Enterprise Communities — The Agreement commits the House and Senate Leadership to seek to include certain other provisions in the tax bill, including the Administration's proposal for expanded Empowerment Zones and Enterprise Communities. Under the 1993 Act, nine Empowerment Zones and ninety-five Enterprise Communities were established. Because of the high demand and the success these demonstration projects have shown in stimulating economic growth to distressed areas, the Administration sought to expand these initiatives. Under the Agreement, there would be twenty additional Empowerment Zones and eighty additional Enterprise Communities. With the exception of Empowerment Zones established in the District of Columbia, the Republicans chose not to follow this part of the Agreement.

Brownfields — In addition, the Republicans chose not to follow the Agreement's commitment to include the President's proposed tax relief for certain remediation costs incurred in cleaning up old contaminated industrial sites or "brownfields." The cost of honoring this part of the Agreement is $900 million. Although this is a small amount within the context of the entire bill, our Republican colleagues made no effort to include this provision in the bill. When this is taken into consideration, in addition to all the other benefits provided under the bill, we can only conclude that the Republicans have stated their priorities, and those priorities do not include environmental cleanup.

Democratic Alternative

The following is a description of the Democratic Alternative that we offered during the Ways and Means Committee markup. It is fairer to working middle-income families, is fiscally responsible, and adheres to the negotiated budget agreement. Unfortunately, every Republican Member voted against our alternative and against achieving these goals.

Dissenting Views of Democratic Members With Respect to Revenue Provisions

C B Rangel — Jim McDermott

William J. Coyne — Ben Cardin

Sander M. Levin — Richard Neal

Mike McNulty — Robert T. Matsui

Pete Stark

Jerry Kleczka

Wm. J. Jefferson — John Lewis

Karen L. Thurman — Barbara B. Kennelly

June, 1997

DEMOCRATIC ALTERNATIVE

I. **Education Tax Benefits**

A. HOPE Scholarship Credit. The alternative includes a nonrefundable HOPE scholarship credit for postsecondary education.

For the first two years of a student's postsecondary education, the HOPE scholarship credit equals 100 percent of tuition costs. The limitation on the amount of the HOPE scholarship credit for the first two years is phased in as follows: $1.100 for 1997.1998 and 1999: $1.200 for 2000. and $1.500 for 2000 and thereafter.

For the remainder of postsecondary education, the HOPE scholarship credit equals 20 percent of tuition costs. There is a limitation on the amount of tuition costs for which the credit is allowable and that limitation is phased in as follows: $4,000 for 1997.1998. and 1999; $5,000 for 2000; $7,500 for 2001; $10,000 for 2002 and thereafter. Consequently, the credit could be worth up to $800 in 1997-1999. $1,000 in 2000. $1.500 in 2001. and $2.000 in 2002 and thereafter.

The HOPE credit is phased out for joint returns between $80,000 and $100,000 of adjusted gross income and for single returns between $50.000 and $70.000 of adjusted gross income.

Scholarships are offset against tuition costs so that the HOPE scholarship credit is allowed for the net tuition costs paid by the taxpayer. Pell Grants and other nontaxable Federal scholarship grants do not reduce the limitations on the amount of the credit. but offset tuition costs like other scholarships.

To be eligible for the HOPE scholarship credit. the student must be at least a half-time student and the student must maintain satisfactory academic progress.

The HOPE scholarship would be effective for payments made for education commencing on or after July 1. 1997.

B. Employer-provided Educational Assistance. There is a provision (Internal Revenue Code section 127) that provides an exclusion from an employee's income (limited to $5.250 per year) for income and employment tax purposes of amounts paid by an employer for education and training of an employee. The provision will expire for education provided after June 30. 1997. Last year's Small Business Tax Act eliminated the exclusion for courses at the graduate level.

The alternative includes a permanent extension of the exclusion of employer-provided educational assistance and reinstates the exclusion for graduate education. The reinstatement of the exclusion for graduate education would take effect for courses beginning after June 30. 1997.

C. Elementary and Secondary Education. The alternative includes a provision that permits local governments to issue special bonds (or otherwise borrow money) to improve elementary and secondary schools. The proceeds of the bonds (or other borrowing) could be used for school construction or improvements, equipment purchases, course materials, or teacher training. The proposal provides a tax credit to the purchaser of the bonds in an amount equal to the interest that would otherwise be paid by the local government. This credit permits the local government to obtain these funds with no interest cost.

This program would be available for schools in empowerment zones or enterprise communities and would also be available for schools in other areas so long as at least 35 percent of the students attending the school are poor. To be eligible to participate in the program, the school must join in a partnership with private businesses which would make contributions to the school.

The amount of the bonds eligible for the credit would be limited to $10 billion per year for the next five years. The overall limitations would be allocated among the States. The State education agency would be responsible for allocating the State share of the bond limit among the schools in that State.

II. Family Credit

The proposal would provide an income tax credit for families with children under age 18. The credit would begin in 1998. The credit would be $300 per child in 1998, 1999, and 2000. $500 in 2001 and thereafter. The credit would phase out for families with incomes between $60.000-$75.000. It would be unavailable to those with more than $75,000. The credit would be allowed against a family's income tax payments and to the extent of the employee share of payroll taxes paid by the parents. In addition, as is the case for all other credits. the family credit would be allowed before any earned income tax credit is computed.

III. Capital Gains

A. As proposed in President Clinton's FY 1998 budget, a taxpayer generally would be able to exclude up to $250.000 ($500,000 on a joint return) of gain realized on the sale or exchange of a principal residence if the taxpayer owned and occupied the principal residence for at least 2 of the prior 5 years.

B. Losses, up to a limit of $250,000, on the sale of a principal residence would be treated as deductible capital losses. (Under current law, losses on home sales are nondeductible personal losses.)

C. Capital gains, up to a lifetime cap of $600,000, on certain assets would be taxed at 18 percent (7.5 percent for taxpayers in the 15-percent regular bracket). This new rate would apply to assets not publicly traded on established securities markets. Thus, the 18-percent rate would apply to gains from the sale of farms, business assets and real estate. but not from financial assets. A 3-year holding period would be required. The new rate would apply for gains from sales on or after May 7. 1997.

IV. **Estate Tax Relief**

Federal estate and gift taxes are imposed on transfers by gift or at death. There is a unified credit allowed against those taxes in an amount which is equivalent to an exemption of the first $600.000 of taxable gifts or of the decedents estate.

The alternative includes an immediate additional exemption for estates 50 percent or more of which consist of family-owned business interests. The additional exemption would equal the first $400,000 of value of the family-owned business interest. When added to the existing $600.000 exemption equivalent, a decedent can pass $1 million tax-free, effective January 1, 1998. So much of the exclusion that is not claimed on the death of the first spouse may be claimed by the estate of the other spouse.

This additional exemption, when combined with the unified credit of current law, would permit family-owned business interest with values up to $2 million to pass without estate tax in the case of a married couple.

The additional exemption would take effect on January 1, 1998 (with no phase-in).

V. Extension of Expiring Provisions

A. R & D Credit. There is a research credit under current law which is generally equal to 20 percent of the amount by which the business' research expenditure exceed a base amount. The credit expired May 31, 1997. The alternative would extend the research credit for one year.

B. Contributions of Appreciated Stock. Under current law, there is a temporary provision that permits full fair-market value deduction for contributions of appreciated stock to private foundations. In the absence of this provision, the taxpayer would be allowed a deduction of no more than the cost of the stock. The alternative extends this provision for an additional year (through May 31, 1998).

C. Work Opportunity Tax Credit. The work opportunity tax credit is an incentive for employers to hire individuals from certain targeted groups. The amount of the credit is 35 percent of the first $6,000 of wages paid to the eligible employee during the first year of employment. The alternative extends the work opportunity credit for an additional year (through September 30, 1998). In addition, the alternative makes the following modification to the credit:

1. The credit would be expanded to cover adults who lost eligibility for food stamps because of the time limits imposed by welfare reform, but who complied with the applicable work requirements. This change would be effective for individuals hired after date of enactment through September 30, 2000.

2. The credit rate would be increased to 40 percent. Employees who work for the employer for at least 120 hours but less than 400 hours would be eligible for a credit at a reduced rate of 25 percent.

D. Orphan Drug Credit. Under current law there is a 50 percent credit (called the Orphan Drug Credit) for clinical testing expenses incurred for drugs for rare diseases or conditions, so-called orphan drugs. The alternative would make this credit permanent.

VI. Other Presidential Initiatives

The alternative includes the following tax provisions as recommended in the President's budget:

A. Expansion of empowerment zones and enterprise communities. The Omnibus Reconciliation Act of 1993 (OBRA '93) targeted to certain economically distressed areas special Federal income tax incentives, such as an employment and training credit, additional section 179 expensing, and a new category of tax-exempt bonds. These targeted areas were designated as empowerment zones (9) and enterprise communities (95).

The proposal would extend the current-law empowerment zones to two additional zones located in urban areas. In addition, certain modifications would be made to the definitions of "enterprise zone businesses" and the tax-exempt private activity bond provision to permit a broader range of businesses in the E Zones and enterprise communities to use the proceeds of these bonds and qualify for the additional section 179 expensing. Finally, the proposal would authorize 20 additional empowerment zones and 80 additional enterprise communities with certain modified eligibility requirements.

B. Brownfield tax incentives. Generally, costs incurred for new buildings or permanent improvements made to increase the value of property (including amounts incurred to prolong the useful life of property or to adapt property to a new or different use) are not currently deductible, but must be capitalized.

The proposal would permit certain remediation costs to be deducted currently if such costs were incurred in connection with the clean-up of certain contaminated sites (environmental contaminants). The qualified sites would be located, generally, in distressed communities that would derive significant economic benefit if the sites were cleaned up and made available for use. Also, the proposal would permit tax-exempt qualified redevelopment bonds to be used to pay environmental remediation expenses for qualified sites.

C. Tax credit for investment in community development financial institutions. The Community Development Banking and Financial Institutions Act of 1994 created the Community Development Financial Institutions (CDFI) Fund to provide equity investments, grants, loans, and technical assistance to qualifying organizations.

The proposal would make available to the CDFI Fund a total of $100 million in nonrefundable tax credits to be allocated among equity investors in qualified CDFIs between 1997 and 2006. The allocation of credits would be determined by the CDFI Fund using a competitive process similar to the one used to allocate $37.5 million in assistance last year.

D. Welfare-to-Work Tax Credit. The proposal would create a new welfare-to-work credit for employers who hire long-term family assistance recipients. The credit would be equal to a maximum amount of 50 percent of the first $10,000 of annual wages paid in the first and second years of employment.

E. Equitable tolling of statute of limitations for incapacitated taxpayers. The proposal would permit the "equitable tolling" of the statute of limitations with respect to filing a claim for a refund of taxes with the Internal Revenue Service for certain mentally or physically incapacitated taxpayers. The statute of limitations would be tolled for the period of time during which the taxpayer was medically determined to be mentally or physically unable to manage his or her financial affairs.

F. Extension and modification of Puerto Rico tax credit. The proposal would modify the current-law section 30A economic-activity credit by extending it indefinitely; making it available to newly established business operations, effective for taxable years beginning after December 31, 1997; and repealing the income cap.

G. Foreign sales corporation benefits for licensed software. The proposal would modify the definition of "export property" to include computer software licensed for reproduction abroad for purposes of qualifying for Foreign Sales Corporation (FSC) benefits.

H. District of Columbia tax incentives. The proposal would provide certain tax incentives for the District of Columbia including a 40-percent wage credit on the first $10,000 of wages paid to employees who are D.C. residents and meet certain other requirements; an additional 20-percent section 179 expensing; and expanded tax-exempt development bonds.

In addition, the proposal would create a new D.C. Economic Development Corporation (EDC) to develop and oversee a comprehensive economic development strategy for D.C. The EDC would be authorized to allocate $95 million in tax credits to taxpayers that make certain equity investments in, or loans to, businesses conducting business activities in D.C. Finally, the proposal would clarify and expand the District's authority to issue general revenue bonds. The EDC would be required to terminate its affairs on or before September 10, 2010.

Additional
DISSENTING VIEWS
OF
REP. XAVIER BECERRA

Like the rest of my Democratic colleagues on the Ways and Means Committee, I was unable to support the Chairman's mark because, without needing to, it disproportionately favors the wealthy over working men and women in addition to threatening America's fiscal balance in future years. I would also like to briefly call attention to two matters of significant importance that, unfortunately, were not in the tax portion of the 1997 reconciliation bill: the Puerto Rico Section 936 tax credit and the "private use" restrictions in the public power industry.

Federal tax incentives for U.S. corporations doing business in the U.S. possessions, including Puerto Rico, have been a part of the Tax Code since 1921. They encourage those firms that have decided to move abroad or start new operations overseas to instead consider investing in Puerto Rico and the other territorial possessions which, after all, are part of the American umbrella. Significantly, that means that these jobs will go not to foreign workers but to Puerto Ricans -- who are U.S. citizens and covered by American laws, including the minimum wage and other workplace protection standards. However, last year's Small Business Job Protection Act, in addition to renumbering the Section 936 credit as Section 30A, terminated the credit for new businesses and phased it out for existing U.S. operations in Puerto Rico over a ten year period.

The possessions tax credit has helped to create a growing middle class in Puerto Rico. However, much work remains to be done, as evidenced by Puerto Rico's 13.8% unemployment rate and abysmal per capita income level -- half that of Mississippi. More than half of the Island's population lives below the poverty line.

Section 936 was derided by some as "corporate welfare" because it enabled corporations to escape U.S. taxation by the amount of their Puerto Rico-sourced income, and was not directly linked to job creation. However, changes made in the Omnibus Budget Reconciliation Act of 1993, and continued in the new Section 30A, ensure that the credit is appropriately focused by tying it to a specified portion of wage and depreciation costs incurred by corporations in Puerto Rico.

We should remember that Puerto Ricans are U.S. citizens and, accordingly, should share in the extraordinary growth of our economy. A vibrant Puerto Rican economy is in the national interest as it will enable Islanders to buy more mainland products. A healthy Island economy also means fewer U.S. possession residents will be forced to leave their homelands for the mainland, looking for work. Considering these national interests, I believe it is prudent that this Congress remove the ban on new businesses claiming the credit and lift the sunset on the possessions tax credit to permit the Puerto Rican economy to achieve a healthy and sustainable rate of growth.

Turning to the "private use" issue, the electric utility industry is undergoing rapid and far-reaching structural changes away from a regulated monopoly and toward free market competition. This paradigm shift is especially prevalent in my home state of California, which recently enacted legislation calling for competition and consumer choice in the electric utility market in the very near future.

Municipal public power companies, like Los Angeles' Department of Water and Power, issue tax-exempt bonds to finance the construction of their generation and transmission facilities. These bonds are subject to restrictions so that the "private use" from a bond-financed project may not exceed the lesser of 10% or $15 million. Violation of this prerequisite can cause the loss of tax-exempt status for bondholders and have adverse financial consequences for both the utilities and the governing municipalities' bond ratings.

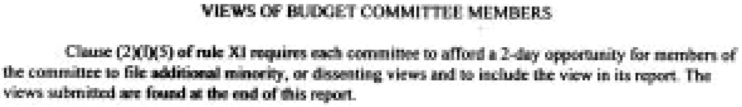
The theory behind the private use restrictions is that tax-exemption is a public benefit which should accrue to the general public, not private entities. For example, it would violate this theory if a municipal public power company financed the construction of a new electric power generating facility with tax-exempt bonds (an economic burden borne by the public), and more than $15 million worth of the facility's output -- at a discounted rate -- was directed to a large corporate customer (an economic benefit received by a private actor). In effect, the cheaper rate enjoyed by the large corporate customer would have been paid for by the public through the tax-exempt financing. This theory is about to crash headlong into the free market theory.

As public power companies in California and the United States enter the new free market regime, they will bump up against the private use restrictions almost immediately, thereby risking the status of their tax-exempt bonds. If by entering the competitive fray those bonds become taxable, municipalities will be instantly sued by their bondholders. On the other hand, if public power companies choose not to compete in the marketplace they will undoubtedly lose market share and, as a consequence, their owners (municipal residents) will also lose out.

This is a complicated area of the law which is constantly changing as the industry moves to a free market regime. Obviously, any changes we make to the private use provisions must not unduly benefit public power companies at the expense of private electric firms. Our goal should be to create a level playing field and then let the marketplace determine the winners and losers in this industry.

The best way to accomplish this might be to "grandfather" existing tax-exempt bonds so that they would not be subject to the private use restrictions and could be used in free market competition. Future construction of public power generation and transmission facilities with tax-exempt bonds should be subject to the private use restrictions; accordingly, future projects intended to compete in the private sector should be built with taxable bonds. Grandfathering existing tax-exempt bonds for public power companies can be viewed in an analogous manner to the stranded cost-recovery strategies proposed by private electric utility firms.

I regret that I could not support this tax bill for the reasons outlined in the Democratic supplemental views. In addition to solving the very serious problems of the Chairman's Mark, I would hope that any tax bill signed into law by the President restores the possessions tax credit and eases the private use restrictions.



VIEWS OF BUDGET COMMITTEE MEMBERS

Clause (2)(l)(5) of rule XI requires each committee to afford a 2-day opportunity for members of the committee to file additional minority, or dissenting views and to include the view in its report. The views submitted are found at the end of this report.

John Spratt
6/23/97

Dissenting Views on the Tax Bill
by Congressman Spratt, Ranking Member

Budget Committee Democrats oppose the tax bill approved by the Ways and Means Committee Republicans because it is inconsistent with the Bipartisan Budget Agreement. Our object is to balance the budget over the long run, not just in 2002, and we think the out-year revenue losses caused by this bill could undercut that objective. Our object also is to distribute tax relief fairly over all income groups, and we believe this bill falls far short of that goal.

Growing Revenue Losses Due to Tax Cuts

In the Budget Agreement, the majority agreed that revenue losses caused by tax cuts would not "explode" in the outyears. The tax bill reported by the Ways and Means Committee pays little heed to that concern, except in trying to mask the outyear consequences. The relative tax relief for typical working Americans--the child tax credit and the HOPE education credits-- becomes, over time, less and less a proportion of total tax relief. Together these tax cuts are 71 percent of total tax cuts during the first five years. But in the second five years, they shrink to 47 percent of the total and to even less in later years.

The Education Tax Cuts

The philosophy of the Budget Agreement was for both sides to win. The Clinton Administration chose what it wanted to win: major educational initiatives. In the tax bill, the one goal the President sought was $35 billion in tax relief through two proposals: tuition tax credits and tuition deductibility. These two forms of education tax relief would be of immediate benefit to typical working families. The bill converts the President's educational proposals into one that is tilted to wealthier Americans and fails to help [illegible] third and fourth year college students.

In the Budget Committee mark-up, the majority unanimously rejected a Democratic request for support of a rule that would allow a vote to include an education tax plan that meets the President's objectives.

Distribution of Tax Cuts

Sixty-eight percent of the tax relief in this bill goes to the top 20 percent of all households. In the Democratic substitute, [illegible] 32 percent goes to the top 20 percent, less than half as much. 68 percent of Democratic tax relief goes to the remaining 80 percent of all households.

In the Budget Committee mark-up, thɔ majority rejected a Democratic request for support of a rule that would allow an amendment to mitigate the marriage penalty, *and* allow payroll-taxpaying low-income families to qualify for the child credit, *and* eliminate the denial of the child credit to families using the dependent care tax credit.

Expanding Tax Cuts

After the year 2002, when the budget is supposed to be balanced, the size of the Republican net tax cut grows rapidly. From that year through 2007, the net tax cut grows at **15 percent per year**, far faster than inflation or real growth in the economy.

Major parts of the tax package have been structured to mask the magnitude of tax cuts through the year 2002, but to let them then grow rapidly. The most rapidly growing tax breaks are those that benefit the wealthy as opposed to the middle class. How these tax breaks have been structured is explained briefly below:

- Capital Gains Tax Cuts — **Revenue loss grows at 20% per year**
  2001 revenue loss: -$3.6 billion [1]
  2007 revenue loss: -10.8 billion

  See Figure 1.

  Initially, the revenue losses are masked by a temporary burst of capital gains realizations that last in part through fiscal year 1999.

  After the year 2001, taxpayers can "buy" inflation indexing for assets already in their portfolio by paying tax on accrued capital gains as though they were selling the assets. The tax bill assumes that $6 billion will be paid in capital gains taxes in 2001 by taxpayers

[1] Because the capital gains tax cut was engineered to temporarily raise revenue in the year 2002, the rate of increase of the revenue loss from that year cannot even be computed. The computation above uses 2001 as the base period.

electing this treatment. There is no experience on which to base this assumption, and many feel that it runs against the grain of most investors to pay substantial capital gains taxes before liquidating their capital assets.

The full revenue losses from inflation-indexing are not apparent until it has been effective long enough to cover the holding period of most assets, which is quite long for real estate. Thus the full revenue losses will not be apparent for a decade or more after the year 2001.

The official congressional revenue estimates build in a "realizations response" to the tax cut that may be over-optimistic. The official revenue loss estimates — after the initial sell off of assets — are only about 37 percent as large as would be lost if there were no change in taxpayer behavior. That is, the estimates assume a very substantial pick-up in the rate of buying and selling assets. However, a recent Congressional Research Service report examines research evidence and concludes that *"The permanent revenue losses from cutting the capital gains tax may be larger than those estimated thorough standard scoring practices for several reasons . . . "*

- Back Loaded Individual Retirement Accounts

Revenue loss grows at 73% per year

2002 revenue loss:	-$0.3 billion
2007 revenue loss:	-$4.6 billion

See Figure 2.

Initially, there is little or no revenue loss from this new form of IRAs because future tax breaks are sold to taxpayers. A "rollover" option effectively allows taxpayers to buy future tax breaks by paying tax in the near term. Taxpayers have the option of rolling over their old-style IRA deposits into new accounts. When they do so, they must pay tax now on the amounts transferred but in exchange later withdrawals from the new accounts, including investment earnings, are tax-free.

Revenue losses begin to emerge in the year 2001, but are small because not a great deal of money on which investment earnings accrue has built up in the accounts. The revenue losses do not fully materialize until the accounts have lasted long enough for larger balances to build up, a process that can take two decades or more.

- Education Savings Accounts

  Revenue loss grows at 17% per year
  2002 revenue loss: -$1.8 billion
  2007 revenue loss: -$4.0 billion

  This is another kind of back-loaded account that allows tax-free accumulation of investment earnings. The revenue loss is small when the accounts are initiated because little money is in the accounts, but they build over time.

- Individual Alternative Minimum Tax (AMT)

  Revenue loss grows at 49% per year
  2002 revenue loss: -$0.7 billion
  2007 revenue loss: -$5.1 billion

  The plan increases the AMT exemption so gradually that the full increase is not effective until the year 2007. This is one way to postpone the full effect of the tax policy and at the same time to mask the effect within the ten-year total.

- Estate Tax Exemption

  Revenue loss grows at 15% per year
  2002 revenue loss: -$2.6 billion
  2007 revenue loss: -$5.3 billion

  The plan increases the effective estate tax exemption slowly so that the full increase is not effective until the year 2007. (The uniform credit is increased from an equivalence of $600,000 to $1,000,000.)

The Bill Fails to Provide Promised Education Tax Relief

The bill fails to include the $35 billion over five years of tax relief consistent with the President's proposals. This was explicitly promised in the Bipartisan Budget Agreement. The President requested Congress to enact two forms of education tax relief that would be of immediate benefit to typical families. The bill converts his request program into one program that provides less relief. Under the bill, only $22 billion over five years goes to help families with the cost of higher education, compared to $35 billion agreed to in the Budget Agreement

The Bill replaces the President's tuition tax deduction with a back-loaded, education savings account.

The essence of the bill's educational substitute is as follows. Investment earnings on funds put into special education accounts are free of tax while they accrue and are not taxed when withdrawn from the accounts if withdrawn to pay for education. The maximum annual contribution per student is $5,000. The accounts are permitted to grow to balances as large as $50,000 per student. Eligible education expenses include "reasonable" room and board, a different treatment for the rewritten HOPE credit.

The President offered tax deductibility for tuition expenses of up to $10,000 for post-secondary education, including graduate education.

Obviously, lower-middle income families are less able to take advantage of the committee's savings account than upper-income families. The record shows that wealthier families derive greater benefit from tax-preferred savings accounts, because they can simply channel what they normally save into tax-preferred accounts.

Consider IRAs, for example. Income-related restrictions were imposed on IRAs after 1986. In that year, 1986, 54 percent of the upper 10 percent of taxpayers used IRAs, compared to 9 percent of those in the middle third of income distribution. In 1986, 82 percent of IRA deductions were taken by the wealthiest one-third of households filing tax returns.

Unlike the President's education deduction, which was limited to middle- and lower-income families, the committee's tax benefit can be used regardless of how high income may be. (In the President's plan, the phase-out interval for joint returns was between $80,000 and $100,000. For single returns, the range was $50,000 to $70,000.) And unlike the President's proposals, the committee's savings accounts are of little use to families with children in college or technical school or about to enter post-secondary education.

Students attending modest-cost institutions receive less benefits under the President's HOPE scholarship.

Instead of the President's 100 percent credit for $1,500 of tuition and required fees, the bill offers a 50 percent credit on up to $3,000 of post-secondary education expenses. A student attending a $1,500 per year community college gets $750 in assistance, as opposed to the President's $1,500 in assistance.

Child Tax Credit

Under the bill, many low-income families will not benefit from the children's credit. Forty-one percent of children under the age of 17 are excluded because their families have income too low to qualify.

Most families getting the EITC will be excluded, even though about half pay net taxes when account is taken of all payroll taxes.

There are nearly 8 million children in families that pay taxes, whose families do not get the children's credit included in the bill.

The majority has also added another innovation: that of reducing the child tax credit by up to half when a family uses the dependent care tax credit to help offset the cost of child care. The policy denies much of the children's credit to six million families, most of whom need to pay for child care so they can work for a living.

In hearings earlier this year, Budget Committee Chairman Kasich said: *"The era of the single-parent-family worker is almost extinct [that] in America today, moms and dads both have to go to work." (February 11, 1997)*

Chairman Kasich is correct. Of twenty-five million married couples with children in 1994, about two-thirds are two-worker families.

The current dependent care credit recognizes that child care is a cost of working. Families should get this tax break, just as businesses get to deduct the reasonable expenses under Section 162.

Capital Gains Tax Cuts

The committee bill includes a double-barreled capital gains tax cut. Its cuts the effective rate to 20% and allows inflation-indexing of investment basis, starting in the year 2001.[3] Indexing is conceptually defensible. It has never been enacted, however, because the

[3] In addition, the corporate tax rate on capital gains would be reduced from a top rate of 35 percent, the same as on other income, to 30 percent, subject to a five-year holding period.

Department of Treasury has always considered it administratively too complex. This bill not only overrides those concerns but couples indexing to a preferentially low rate.

According to the Congressional Research Service, these two tax breaks together are equivalent to making 65 to 60 percent of capital gains tax-free.

When taxpayer incomes and capital gains are averaged — to wash out the effect of infrequent large gains — the gains are clear. For example, by examining a 10-year "panel" of taxpayers, CBO researchers calculated that 73 percent of capital gains were realized by the 3 percent of taxpayers with incomes over $100,000 (1993 dollars).

See Figure 3.

The nonpartisan Tax Section of the New York Bar Association has testified that it *"strongly opposes indexing, because it will vastly increase the complexity of the tax system and it will lead to the return of the tax shelter days of the 1980s." "Activities that are relatively simple today will involve massive calculations under indexing."*

In 1991, the Republican staff of the House Budget Committee wrote *"Sadly, most evidence suggests that saving is unresponsive to any tax incentives designed to increase it. And capital gains tax cuts and IRAs only affect a small part of saving. Even the most optimistic estimates of the responsiveness of savings to taxes are too low to support the argument that such incentives significantly boost savings and growth."*

Figure 1

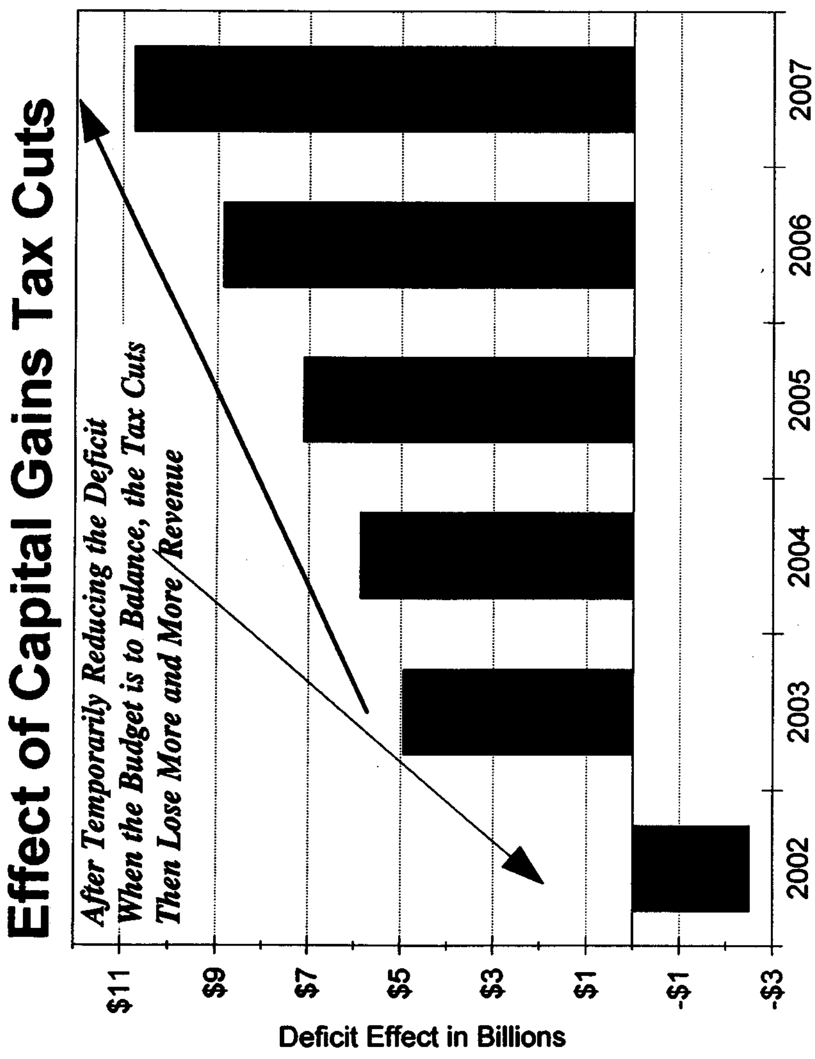

Effect of Capital Gains Tax Cuts
After Temporarily Reducing the Deficit
When the Budget is to Balance, the Tax Cuts
Then Lose More and More Revenue
$11
$9
$7
$5
$3
$1
-$1
-$3
Deficit Effect in Billions
2002
2003
2004
2005
2006
2007

Figure 2

Effect of Back Loaded IRAs

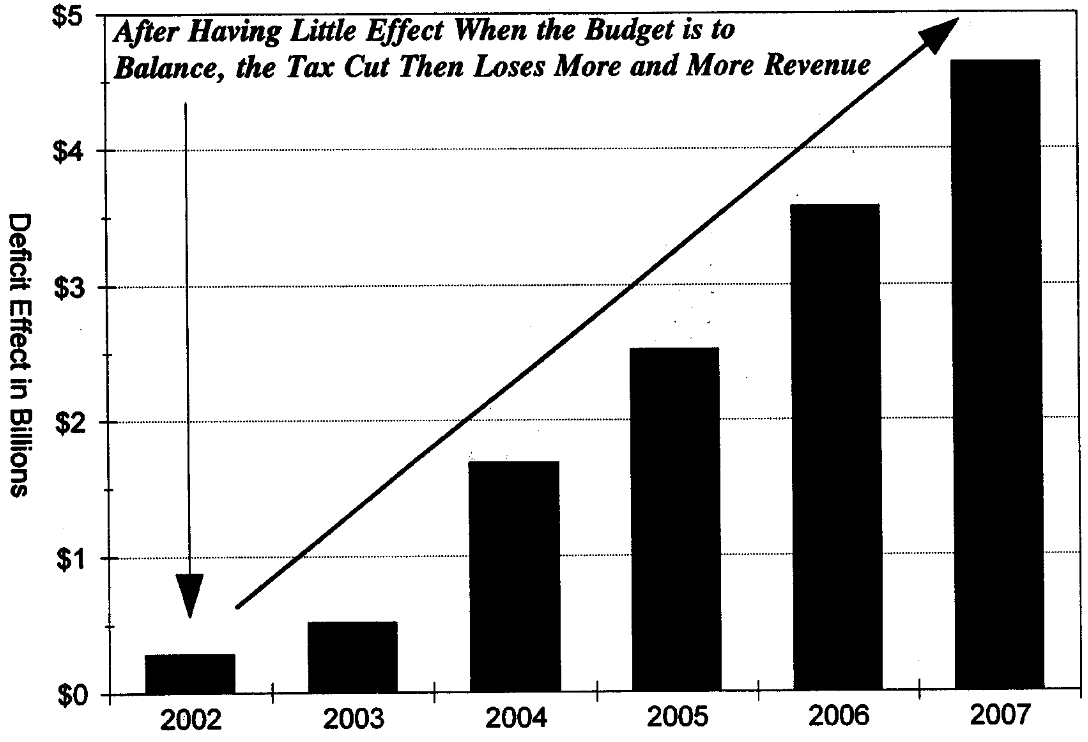
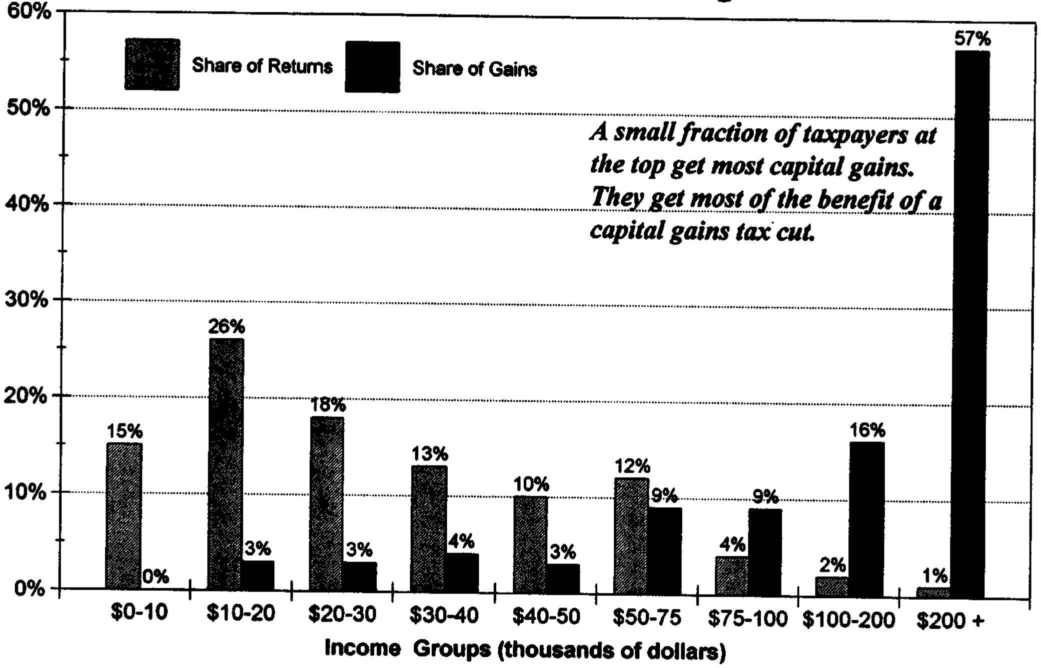


Figure 3

Capital Gains Go Mostly to the Top
Even Using 10-Year Averages



A small fraction of taxpayers at the top get most capital gains. They get most of the benefit of a capital gains tax cut.

Source: CBO "Perspectives on the Ownership of Capital Assets and the Realization of Capital Gains, May 1997.