DESCRIPTION OF THE
THE TAXPAYER REFUND ACT OF 1999

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

on July 20, 1999

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

July 16, 1999

JCX-46-99

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions in the Taxpayer Refund Act of 1999. The Senate Committee on Finance is scheduled to mark up these proposals beginning on July 20, 1999.

This document contains descriptions of the following provisions in the Chairman's Mark: (1) broad-based tax relief provisions, (2) family tax relief provisions, (3) retirement savings tax relief provisions, (4) education tax relief provisions, (5) health care tax relief provisions, (6) small business tax relief provisions, (7) estate and gift tax relief provisions, (8) tax-exempt organization provisions, (9) international tax relief provisions, (10) housing and real estate tax relief provisions, (11) miscellaneous provisions, (12) extension of expired and expiring provisions, (13) revenue offset provisions, and (14) tax technical correction provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Taxpayer Refund Act of 1999* (JCX-46-99) July 16, 1999.

I. BROAD-BASED TAX RELIEF -- REDUCTION IN THE 15-PERCENT REGULAR INDIVIDUAL INCOME TAX RATE

Present Law

Income tax rate structure

To determine regular income tax liability, a 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. The income bracket amounts are indexed for inflation. Separate rate schedules apply based on an individual's filing status. In order to limit multiple uses of a graduated rate schedule within a family, the net unearned income of a child under age 14 is taxed as if it were the parent's income. For 1999, the individual regular income tax rate schedules are shown below.

Table 1.–Federal Individual Income Tax Rates for 1999

If taxable income is:	**Then income tax equals**:
Single individuals	
$0-25,750	15 percent of taxable income
$25,750-$62,450	$3,862.50, plus 28% of the amount over $25,750
$62,450-$130,250	$14,138.50 plus 31% of the amount over $62,450
$130,250-$283,150	$35,156.50 plus 36% of the amount over $130,250
Over $283,150	$90,200.50 plus 39.6% of the amount over $283,150
Heads of households	
$0-$34,550	15 percent of taxable income
$34,550-$89,150	$5,182.50 plus 28% of the amount over $34,550
$89,150-$144,400	$20,470.50 plus 31% of the amount over $89,150
$144,400-$283,150	$37,598 plus 36% of the amount over $144,400
Over $283,150	$87,548 plus 39.6% of the amount over $283,150
Married individuals filing joint returns	
$0-$43,050	15 percent of taxable income
$43,050-$104,050	$6,457.50 plus 28% of the amount over $43,050
$104,050-$158,550	$23,537.50 plus 31% of the amount over $104,050
$158,550-$283,150	$40,432.50 plus 36% of the amount over $158,550
Over $283,150	$85,288.50 plus 39.6% of the amount over $283,150

Description of Proposal

The proposal would reduce the lowest individual regular income tax rate from 15 percent to 14 percent. This rate reduction would not apply to the capital gains tax rates. The proposal would also increase the size of the otherwise applicable 14-percent rate bracket by $2,000 ($4,000 for a married couple filing a joint return) beginning in 2005 and by $2,500 ($5,000 for a married couple filing a joint return) beginning in 2007.

Effective Date

The proposal to reduce the rate from 15 percent to 14 percent would be effective for taxable years beginning after December 31, 2000. The proposal to increase the size of the rate bracket would be effective for taxable years beginning after December 31, 2004.

II. FAMILY TAX RELIEF PROVISIONS

A. Election to Calculate Combined Tax as Individuals for a Married Couple Filing a Joint Return

Present Law

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose incomes are split more evenly than 70-30 suffer a marriage penalty. Married couples whose incomes are largely attributable to one spouse generally receive a marriage bonus.

Under present law, the size of the standard deduction and the tax bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and tax bracket breakpoints for single filers are roughly 60 percent of those for joint filers.[2] With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals.

Description of Proposal

Under the proposal, married taxpayers would have the option to calculate separate taxable income for each spouse and to be taxed as two single individuals on the same return. The tax due would be calculated by applying the tax rates for single individuals to the separate taxable incomes. Under the proposal, the two spouses would elect to either use a standard deduction or to itemize their deductions. Thus, one spouse would not be permitted itemize deductions while the other spouse claimed a standard deduction. If a married couple elects to compute taxable income separately and claim the standard deduction, the applicable standard deduction for each spouse would be the standard deduction for single individuals. Under the proposal, one tax liability is calculated on a separate basis, all tax credits and payments of tax are applied as if the couple is

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[2] This is not true for the 39.6-percent rate. The beginning point of this rate bracket is the same for all taxpayers regardless of filing status.

filing a joint return.

Income from the performance of services (e.g., wages, salaries, and pensions) would be treated as the income of the spouse who performed the services. Income from property would be divided between the spouses in accordance with their respective ownership rights in such property. Jointly owned assets would be divided evenly.

Deductions generally would be allocated to the spouse treated as having the income to which the deduction relates. Special rules would apply for certain deductions. The deduction for contributions to an individual retirement arrangement would be allocated to the spouse for whom the contribution is made. The deduction for alimony would be allocated to the spouse who has the liability to pay the alimony. The deduction for contributions to medical savings accounts would be allocated to the spouse with respect to whose employment or self employment the account relates.

Each spouse would be entitled to claim one personal exemption. Exemptions for dependents would be allocated based on each spouse's relative income.

All credits would be determined as if the spouses had filed a joint return. The credit amounts would then be applied against the combined tax liability of the couple.

The Secretary of the Treasury would be directed to prescribe such regulations as may be necessary or appropriate to carry out the provisions of the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2004.

B. Marriage Penalty Relief
Relating to the Earned Income Credit

Present Law

Certain eligible low-income workers are entitled to claim a refundable earned income credit ("EIC") on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the individual's earned income up to an earned income amount. 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. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is phased out above certain income levels. For individuals with earned income (or modified AGI, if greater) in excess of the beginning of the phase-out range, the maximum credit amount is reduced by the phase-out rate multiplied by the earned income (or modified AGI, if greater) in excess of the beginning of the phase-out range. For individuals with earned income (or modified AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

The parameters of the credit for 1999 are provided in the following table.

Earned Income Credit Parameters (1999)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	$9,540	$6,800	$4,530
Maximum credit	$3,816	$2,312	$347
Phase-out begins	$12,460	$12,460	$5,670
Phase-out rate (percent)	21.06	15.98	7.65
Phase-out ends	$30,580	$26,928	$10,200

Description of Proposal

The proposal would increase the beginning point of the phase out of the EIC for married couples filing a joint return by $2,000. Because the rate of the phase out is not changed by the proposal, the end-point of the phase-out ranges would also be increased by $2,000. The effect of the increase in the beginning point of the phase-out is to increase the EIC for taxpayers in the phase-out range by an amount up to $2,000 times the phase-out rate. For example, for couples with two or more qualifying children, the maximum increase in the EIC as a result of the proposal would be

$2,000 times 21.06 percent, or $421.20. The $2,000 amount would be indexed for inflation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2004.

C. Expand the Exclusion from Income for Certain Foster Care Payments

Present Law

Generally, a foster care provider may exclude qualified foster care payments, (including difficulty of care payments) from gross income if certain requirements are satisfied.[3] First, such payments must be paid to the foster care providers by either (1) a State or political subdivision of a State; or (2) a tax-exempt placement agency. Second, the payments, including difficulty of care payments, must be paid to the foster care provider for the care of a "qualified foster individual" in the foster care provider's home. A qualified foster individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the State or a political subdivision of a State; or (2) a tax-exempt placement agency if such individual was under the age of 19 at the time of placement. Third, the exclusion of foster care payments generally applies to qualified foster care payments for five or fewer foster care individuals over the age of 19 in a foster home. In the case of difficulty of care payments, the exclusion applies to payments for ten or fewer foster care individuals under the age of 19 in a foster home and to payments for five or fewer foster care individuals at least age 19 in a foster home.

Description of Proposal

The proposal would make two principal modifications to the exclusion. First, the proposal would expand the list of persons eligible to make qualified foster care payments. Therefore, the exclusion would apply to qualified payments made pursuant to a foster care program of a State or local government which are paid by either: (1) a State or political subdivision of a State; or (2) a qualified foster care placement agency, whether taxable or tax-exempt. Second, the proposal would expand the list of persons eligible to place foster care individuals to allow placements by either: (1) a State or a political subdivision of a State; or (2) a qualified foster care placement agency, whether taxable or tax-exempt. For these purposes, a qualified foster care placement agency would be defined as any placement agency which is licensed or certified by: (1) a State or political subdivision of a State; or (2) an entity designated by a State or political subdivision thereof, for the foster care program of such State or political subdivision to make payments to providers of foster care.

The proposal would allow State and local governments to employ both tax-exempt and taxable entities to administer their foster care programs more efficiently; however, it would not extend the exclusion to payments outside such foster care programs (e.g., payments to a foster care provider from friends or relatives of a foster care individual in the provider's care).

Effective Date

[3] A difficulty of care payment is a payment designated by the person making such payment as compensation for providing the additional care of a qualified foster care individual which is required by reason of a physical, mental, or emotional handicap of such individual and with respect to which the State has determined that there is a need for additional compensation.

The proposal would be effective for taxable years beginning after December 31, 1999.

D. Increase and Expand the Dependent Care Credit

Present Law

In general

A taxpayer who maintains a household which includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related dependent care expenses. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual or $4,800 if there are two or more qualifying individuals. Generally, a qualifying individual is a dependent under the age of 13 or a physically or mentally incapacitated dependent or spouse. No credit is allowed for any qualifying individual unless a valid taxpayer identification number ("TIN") has been provided for that individual. A taxpayer is treated as maintaining a household for a period if the taxpayer (or the taxpayer's spouse, if married) provides more than one-half the cost of maintaining the household for that period. In the case of married taxpayers, the credit is not available unless they file a joint return.

Employment-related dependent care expenses are expenses for the care of a qualifying individual incurred to enable the taxpayer to be gainfully employed, other than expenses incurred for an overnight camp. For example, amounts paid for the services of a housekeeper generally qualify if such services are performed at least partly for the benefit of a qualifying individual; amounts paid for a chauffeur or gardener do not qualify.

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 has no earned income, generally no credit is allowed.

The 30-percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income ("AGI") above $10,000.

Interaction with employer-provided dependent care assistance

For purposes of the dependent care credit, the maximum amounts of employment-related expenses ($2,400/$4,800) are reduced to the extent that the taxpayer has received employer-provided dependent care assistance that is excludable from gross income (sec. 129). The exclusion for dependent care assistance is limited to $5,000 per year and does not vary with the number of children.

Description of Proposal

The proposal would make two changes to the dependent care tax credit. First, the maximum credit percentage would be increased from 30 percent to 50 percent for taxpayers with AGI of $30,000 or less. The 50-percent credit rate would be decreased by one percentage point for each $1,000 of AGI, or fraction thereof, between $30,001 and $59,000. The credit percentage would be

20 percent for taxpayers with AGI of $59,001 or greater. Second, the maximum amount of eligible employment-related expenses ($2,400/$4,800).

The present-law reduction of the dependent care credit for employer-provided dependent care assistance would not be changed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

E. Tax Credit for Employer-Provided Child Care Facilities

Present Law

Generally, present law does not provide a tax credit to employers for supporting child care or child care resource and referral services.[4] An employer, however, may be able to claim such expenses as deductions for ordinary and necessary business expenses. Alternatively, the employer may be required to capitalize the expenses and claim depreciation deductions over time.

Description of Proposal

Employer tax credit for supporting employee child care

Under the proposal, taxpayers would receive a tax credit equal to 25 percent of qualified expenses for employee child care. These expenses would include costs incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of a taxpayer's qualified child care facility; (2) for the operation of a taxpayer's qualified child care facility, including the costs of training and continuing education for employees of the child care facility; or (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer. To be a qualified child care facility, the principal use of the facility must be for child care, and the facility must be duly licensed by the State agency with jurisdiction over its operations. Also, if the facility is owned or operated by the taxpayer, at least 30 percent of the children enrolled in the center (based on an annual average or the enrollment measured at the beginning of each month) must be children of the taxpayer's employees. If a taxpayer opens a new facility, it must meet the 30-percent employee enrollment requirement within two years of commencing operations. If a new facility failed to meet this requirement, the credit would be subject to recapture.

To qualify for the credit, the taxpayer must offer child care services, either at its own facility or through third parties, on a basis that does not discriminate in favor of highly compensated employees.

Employer tax credit for child care resource and referral services

Under the proposal, a taxpayer would be entitled to a tax credit equal to 10 percent of expenses incurred to provide employees with child care resource and referral services.

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[4] An employer may claim the welfare-to-work tax credit on the eligible wages of certain long-term family assistance recipients. For purposes of the welfare-to-work credit, eligible wages includes amounts paid by the employer for dependent care assistance.

Other rules

Total credits that may be claimed under this proposal would be capped at $150,000 per year. Any amounts for which the taxpayer may otherwise claim a tax deduction would be reduced by the amount of these credits. Similarly, if the credits are taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility would be reduced by the amount of the credits.

Effective Date

The credits would be effective for taxable years beginning after December 31, 2000.

F. Modify Individual Alternative Minimum Tax

Present Law

In general

Present law imposes a minimum tax ("AMT") on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The AMT is imposed on individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent on the remaining AMTI. The exemptions 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 AMTI 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. The lower capital gains rates applicable to the regular tax apply for purposes of the AMT.

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.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to

gains on the sale of certain small business stock).

In addition, losses from any tax shelter, farm, or passive activities are denied.[5]

Adjustments in computing AMTI

The adjustments that individuals must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) Miscellaneous itemized deductions are not allowed.

(6) Itemized deductions for State, local, and foreign real property taxes, State and local personal property taxes, and State, local, and foreign income, war profits, and excess profits taxes are not allowed.

(7) Medical expenses are allowed only to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI).

(8) Standard deductions and personal exemptions are not allowed.

(9) The amount allowable as a deduction for circulation expenditures must be capitalized

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[5] Given the passage of section 469 by the Tax Reform Act of 1986 (relating to the deductibility of losses from passive activities), these provisions are largely "deadwood."

and amortized over a 3-year period.

(10) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period.[6]

(11) The regular tax rules relating to incentive stock options do not apply.

<u>Other rules</u>

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable credits allowed under the regular tax generally are allowed only to the extent that the individual's regular tax exceeds the tentative minimum tax. The earned income credit and the child credit of those taxpayers with three or more qualified children are refundable credits and may offset the taxpayer's tentative minimum tax. However, a taxpayer must reduce these refundable credits by the taxpayer's AMT.[7]

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax in such subsequent year. For individuals, the AMT credit is allowed only to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature. Most individual AMT adjustments relate to itemized deductions and personal exemptions and are not timing in nature.

<u>Description of Proposal</u>

The proposal would allow an individual to offset the entire regular tax liablity (without regard to the minimum tax) by the nonrefundable personal credits, and would repeal the provision reducing the refundable child credit by the AMT.

The proposal would also allow the deduction for personal exemptions in computing AMT.

<u>Effective Dates</u>

The provisions relating to the limit on personal credits and the offset of the refundable child credit would be effective for taxable years beginning after December 31, 1998.

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[6] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

[7] For 1998 only, the nonrefundable personal credits were not limited by the tentative minimum tax, and the refundable child credit was not reduced by the minimum tax.

The provision relating to the deduction for personal exemptions would be effective for taxable years beginning after December 31, 2004.

III. RETIREMENT AND INDIVIDUAL SAVINGS TAX RELIEF PROVISIONS

A. Individual Savings Provisions

1. Individual retirement arrangements ("IRAs")

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contribution) differs.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of $2,000 or the individual's compensation if the individual and the individual's spouse are not active participants in an employer-sponsored retirement 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 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 for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Single Taxpayers

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

Joint Returns

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

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out for taxpayers with AGI between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to an traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2 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, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into an Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over 4 years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in 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 for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies).[8] The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Description of Proposal

Increase in annual contribution limits

The proposal would increase the annual contribution limit for traditional IRAs and Roth IRAs in $1,000 annual increments, beginning in 2001, until the limit reaches $5,000 in 2005. Thereafter, the limit would be indexed for inflation in $100 increments.

Increase in AGI limits for deductible IRA contributions

Under the proposal, the AGI phase-out limits for active participants in an employer-sponsored plan would be increased annually by $2,000 ($4,000 in the case of married taxpayers filing a joint return) for 2001-2003 and by $2,500 ($5,000 in the case of married taxpayers filing a joint return) for 2004-2008. After 2008, the income limits would be indexed for inflation. These increases would be in addition to the amount of the increases scheduled under present law. Thus, the phase-out limits would be as follows for taxable years beginning in 2001-2009.

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[8] Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

Single Returns

Taxable years beginning in:	*Phase-out range*
2001	$35,000-45,000
2002	38,000-48,000
2003	46,000-56,000
2004	53,500-63,500
2005	61,000-71,000
2006	63,500-73,500
2007	66,000-76,000
2008	68,500-78,500

Joint Returns

Taxable years beginning in:	*Phase-out range*
2001	$57,000-67,000
2002	62,000-72,000
2003	72,000-82,000
2004	82,000-92,000
2005	92,000-102,000
2006	102,000-112,000
2007	112,000-132,000
2008	117,000-137,000

The present-law income phase-out range for an individual who is not an active participant, but whose spouse is, would remain at $150,000 to $160,000.

AGI limits for Roth IRAs

The proposal would repeal the Roth IRA contribution AGI phase-out limits. The proposal would also increase the AGI limit on conversions of traditional IRAs to Roth IRAs to $1 million. This $1 million limit would apply to all taxpayers, including married taxpayers filing separate returns.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

2. Creation of individual development accounts

Present Law

There are no tax benefits to encourage financial institutions to match savings of low-income individuals.

Description of Proposal

In general

The proposal would create individual development accounts ("IDA"s) to which eligible individuals could contribute. In addition, the proposal would provide a tax credit for certain matching contributions made to an IDA by the financial institution maintaining the IDA. Eligible individuals would be individuals who are: (1) at least 18 years of age; (2) a citizen or legal resident of the United States; and (3) a member of a household eligible for the earned income credit, Temporary Assistance for Needy Families ("TANF"), or with family gross income of 60 percent or less of area median gross income and net worth of $10,000 or less.

Contributions to an IDA by eligible individuals

Only eligible individuals would be allowed to contribute to an IDA. Contributions to IDAs by individuals would not be deductible, and earnings on such contributions would be includible in income.

Matching contributions

The proposal would provide a tax credit to financial institutions that make matching contributions to IDAs of individuals.[9] The tax credit would equal 85 percent of matching contributions of up to a maximum annual credit of $300 per eligible individual. The credit would be available in each year that a matching contribution is made. Financial institutions could reduce Federal tax deposits by the amount of the credit.

Matching contributions (and earnings thereon) would not be includible in the gross income of the eligible individual.

If an individual withdraws his or her own IDA contributions (or earnings thereon) for a purpose other than a qualified purpose, the matching contribution attributable to such individual

[9] Matching contributions (and earnings) would be accounted for separately from individual IDA contributions (and earnings).

contribution would be forfeited.[10] Matching contributions could be withdrawn only for qualified purposes.

A qualified purpose distribution would be a distribution used for (1) certain educational expenses, (2) first-time homebuyer expenses, and (3) business start-up expenses.

Effect on means-tested programs

Any amounts in the IDA would not be taken into account for certain Federal means-tested programs.

Effective Date

The proposal would be effective for contributions to IDAs and matching contributions made with respect to such IDAs after December 31, 2000, and before January 1, 2006.

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[10] The financial institution would be required to adjust tax deposits to take into account forfeitures of matching contributions.

B. Expanding Coverage

1. Option to treat elective deferrals as after-tax contributions

Present Law

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in 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 for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).[11]

Description of Proposal

A section 401(k) plan or a section 403(b) annuity would be permitted to include a "qualified plus contribution program" that would permit a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated plus contributions. Designated plus contributions would be elective deferrals that the participant designates as not excludable from the participant's gross income.

The annual dollar limitation on a participant's designated plus contributions would be the section 402(g) annual limitation on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as designated plus contributions. Designated plus contributions would be treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Under a section 401(k) plan, designated plus

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[11] Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

contributions also would be treated as any other elective deferral for purposes of the special nondiscrimination requirements.

The plan would be required to establish a separate account, and maintain separate recordkeeping, for a participant's designated plus contributions (and earnings allocable thereto). A qualified distribution from a participant's designated plus contributions account would not be includible in the participant's gross income. A qualified distribution would be a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.[12] The nonexclusion period would be the 5-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a designated plus contribution to any designated plus contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated plus contribution account that is the source of the distribution from a designated plus contribution account established for the participant under another plan, the first taxable year for which the participant made a designated plus contribution to the previously established account.

A distribution from a designated plus contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals would not be a qualified distribution.

A participant would be permitted to roll over a distribution from a designated plus contributions account only to another designated plus contributions account or a Roth IRA of the participant.

The Secretary of the Treasury would be directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated plus contributions to make such returns and reports regarding designated plus contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

2. Increase elective contribution limits

Present Law

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the

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[12] A qualified special purpose distributions, as defined under the rules relating to Roth IRAs, would not qualify as a tax-free distribution from a designated plus contributions account.

employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,000 (for 1999). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,000. These limits are indexed for inflation in $500 increments.

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,000 (for 1999) or (2) 33-1/3 percent of compensation. The $8,000 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Description of Proposal

Beginning in 2001, the proposal would increase the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs in $1,000 annual increments until the limits reach $15,000 in 2005. Beginning in 2001, the proposal would increase the maximum annual elective deferrals that could be made to a SIMPLE plan in $1,000 annual increments until the limit reaches $10,000 in 2004. The $15,000 and $10,000 dollar limits would be indexed in $500 increments, as under present law.

Section 457 plans

The proposal would increase the dollar limit on deferrals under a section 457 plan to $9,000 in 2001, $10,000 in 2002, $11,000 in 2003, and $12,000 in 2004. After 2004, the limit would be indexed $500 increments. The limit would be twice the otherwise applicable dollar limit in the three years prior to retirement.[13]

Effective Date

The proposal would be effective for years beginning after December 31, 2000, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement.

3. Plan loans for subchapter S shareholders, partners, and sole proprietors

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[13] Another provision of the proposal would increase the 33-1/3 percentage of compensation limit to 100 percent.

Present Law

The Internal Revenue Code prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.[14] Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Department of Labor can grant an administrative exemption from the prohibited transaction rules if she finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to transactions in which the plan makes a loan to an owner-employee.[15] Thus, owner-employees wishing to engage in such a transaction with a plan must obtain an administrative exemption. For purposes of these rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100 percent of the amount involved.

Description of Proposal

The proposal would generally eliminate the special present-law rules relating to plan loans made to an owner-employee. Thus, the general statutory exemption would apply to such transactions. Present law would apply with respect to IRAs.

Effective Date

The proposal would be effective with respect to transactions entered into after December 31, 2000.

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[14] Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") also contains prohibited transaction rules. The Code and ERISA provisions are substantially similar, although not identical.

[15] Certain transactions involving a plan and Subchapter S shareholders are permitted.

4. Elective deferrals not taken into account for purposes of deduction limits

Present Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

Description of Proposal

Under the proposal, elective deferral contributions would not be subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan would not take into account elective deferral contributions.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

5. Reduce PBGC premiums for small and new plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay benefits promised under the plan. The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. The amount of the required annual PBGC premium for a single-employer plan is generally a flat rate premium of $19 per participant and an additional variable rate premium based on a charge of $9 per $1,000 of unfunded vested benefits. Unfunded vested benefits under a plan generally means (1) the unfunded current liability for vested benefits under the plan, over (2) the value of the plan's assets, reduced by any credit balance in the funding standard account. No variable rate premium is imposed for a year if contributions to the plan were at least equal to the full funding limit.

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than 5 years, and with respect to benefit increases from a plan amendment that was in effect for less than 5 years before termination of the plan.

Description of Proposal

Reduced flat-rate premiums for new plans of small employers

Under the proposal, for the first five plan years of a new single-employer plan of a small employer, the flat-rate PBGC premium would be $5 per plan participant.

A small employer would be a contributing sponsor that, on the first day of the plan year, has 100 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor would be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributes, employees of all contributing sponsors (and their controlled group members) would be taken into account in determining whether the plan is a plan of a small employer.

A new plan would mean a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as are in the new plan.

Reduced variable PBGC premium for new and small employer plans

The proposal would provide that the variable premium is phased in for "new defined benefit plans" over a six-year period starting with the plan's first plan year. The amount of the variable premium would be a percentage of the variable premium otherwise due, as follows: 0 percent of the otherwise applicable variable premium in the first plan year; 20 percent in the second plan year; 40 percent in the third plan year; 60 percent in the fourth plan year; 80 percent in the fifth plan year; and 100 percent in the sixth plan year (and thereafter).

A new defined benefit plan would be defined as under the flat-rate premium proposal relating to new small employer plans.

Effective Date

The proposals relating to new plans would be effective for plans established after December 31, 2000. The proposal reducing the PBGC variable premium for small plans would be effective for years after December 31, 2000.

6. Eliminate IRS user fees for requests regarding new plans

Present Law

An employer that maintains a retirement plan for the benefit of its employees may request from the Internal Revenue Service ("IRS") a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (sec. 401(a)), as well as other rulings and opinions concerning the plan. In order to obtain from the IRS a determination letter on the qualified status of the plan, a ruling or an opinion, the employer must pay a user fee. For example, the user fee for a determination letter request may range from $125 to $1,250, depending upon the scope of the request and the type and format of the plan.[16]

Description of Proposal

No user fee would be required for any determination letter, ruling, or opinion with respect to a new retirement plan. For purposes of the proposal, a new retirement plan would be a plan maintained by one or more employers that (1) have not made a prior request for a determination letter, ruling, or opinion with respect to the plan or any predecessor plan, and (2) have not established or maintained a qualified plan with respect to which contributions were made, or benefits accrued for service, in the 3 most recent taxable years ending prior to the first taxable year in which the request is made.

Effective Date

The proposal would be effective for determination letter requests made after December 31, 2000.

7. SAFE annuities and trusts

Present Law

[16] User fees are statutorily authorized; however, the IRS sets the dollar amount of the fee applicable to any particular type of request.

A small business may establish a simplified defined contribution retirement plan called a savings incentive match plan for employees ("SIMPLE") retirement plan. An employer is eligible to adopt a SIMPLE plan if the employer employs 100 or fewer employees who received at least $5,000 in compensation during the preceding year and does not maintain another retirement plan.

A SIMPLE plan may be either an individual retirement arrangement for each employee ("SIMPLE IRA") or part of a qualified cash or deferred arrangement (a "SIMPLE 401(k)"). A SIMPLE IRA is not subject to the nondiscrimination rules or top-heavy rules generally applicable to qualified plans. Similarly, a SIMPLE 401(k) is deemed to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules apply to a SIMPLE 401(k), however.

SIMPLE plans are subject to special contribution rules. Employees may elect during the 60-day period preceding a plan year to make elective contributions under a SIMPLE plan of up to $6,000 during the plan year. The $6,000 dollar limit is adjusted for cost-of-living increases in $500 increments.

An employer that maintains a SIMPLE plan generally is required to match each employee's elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. As an alternative to a matching contribution for any year, an employer may make a nonelective contribution on behalf of each eligible employee equal to 2 percent of the employee's compensation.

Under a SIMPLE IRA, the compensation limit does not apply for purposes of the required employer matching contribution. If the employer satisfies the contribution requirement by making a nonelective contribution, however, the amount of compensation taken into account for each participant to determine the amount of the required employer contribution may not exceed the compensation limit.

Under a SIMPLE 401(k), the compensation limit applies for purposes of the matching contribution as well as the nonelective contribution.

No contributions other than employee elective contributions and required employer contributions may be made to a SIMPLE plan. All contributions under a SIMPLE plan must be fully vested.

Present law does not provide for a simplified defined benefit plan similar to the SIMPLE plan.

Description of Proposal

A small business would be permitted to establish a simplified retirement plan called the secure assets for employees ("SAFE") plan. The SAFE plan would combine the features of a defined benefit plan and a defined contribution plan.

Employer and employee eligibility and vesting

An employer would be eligible to adopt a SAFE plan if the employer employs 100 or fewer employees who received at least $5,000 in compensation during the preceding year and does not maintain another retirement plan other than a plan that provides only for elective deferrals or matching contributions, an eligible deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan"), or a collectively bargained plan.

Each employee whose compensation was at least $5,000 in any 2 preceding consecutive years and in the current year generally would be eligible to participate. All benefits under a SAFE plan would be fully vested at all times.

Benefits and funding

A SAFE plan would provide a fully funded minimum defined benefit. For each year of participation, a participant generally would accrue a minimum annual benefit at retirement equal to 3 percent of the participant's compensation for the year. The employer would be permitted to elect to provide a benefit of 2 percent, 1 percent, or 0 percent of compensation for any year for all participants if the employer notifies the participants of such lower percentage within a reasonable period before the beginning of the year. Benefits under a SAFE plan would be subject to the annual limitation on compensation that may be taken into account under a qualified plan ($160,000 in 1999).

An employer would be permitted to count up to 10 years of service performed by a participant before the adoption of a SAFE plan ("prior service year") if the same number of prior service years is available to all employees eligible to participate in the SAFE plan for the first plan year. Prior service years would be taken into account by doubling the amount of the contribution the employer would otherwise make for each participant with prior service years, beginning with the first year the SAFE plan is in effect. A participant's prior service years would not include any years in which a participant was an active participant in any defined benefit plan maintained by the employer or received less than $5,000 in compensation from the employer.

Each year the employer would be required to contribute to the SAFE plan on behalf of each participant an amount sufficient to provide the annual benefit accrued for the year payable at age 65, using specified actuarial assumptions (including an interest rate not less than 3 percent and not greater than 5 percent per year). A SAFE plan would be funded either through an individual retirement annuity for each employee ("SAFE Annuity") or through a trust (a "SAFE Trust").

Under a SAFE Trust, each participant would have an account to which actual investment returns would be credited. If a participant's account balance were less than the total of past employer contributions credited with a specified interest rate (not less than 3 percent and not greater than 5 percent per year), the employer would be required to make up the shortfall. If the investment returns in a participant's account exceed the specified interest rate, the participant would be entitled to the larger account balance. Permissible investments of a SAFE Trust would be securities that are readily tradable on an established securities market and insurance company products that are regulated by State law.

Under a SAFE Annuity, each year the employer would be required to contribute the amount necessary to purchase an annuity that provides the benefit accrual for the year.

The required contributions to a SAFE plan would be deductible under the rules applicable to qualified defined benefit plans. An excise tax would apply if the employer fails to make the required contribution for the year.

Benefits under a SAFE plan would not be guaranteed by the Pension Benefit Guaranty Corporation.

Distributions

A SAFE plan would be permitted to provide for distributions at any time. Distributions from a SAFE plan would be subject to tax under the present-law rules applicable to distributions from qualified plans, except that a distribution prior to the participant's attainment of age 59-1/2 generally would be subject to an additional tax equal to 20 percent of the amount distributed.

A SAFE plan would be required to provide for payment of benefits in the form of a single life annuity payable at age 65 or any actuarially equivalent form of benefit. A SAFE plan would not be subject to the joint and survivor annuity requirements applicable to other defined benefit pension plans.

Nondiscrimination requirements and other rules

A SAFE plan would not be subject to the nondiscrimination rules, the top-heavy plan rules, or the limitations on benefits or contributions applicable to qualified retirement plans. Simplified reporting and disclosure requirements would apply to SAFE plans.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

8. Compensation limit not to apply to SIMPLE 401(k) plans

Present Law

The annual compensation of each participant that may be taken into account under a qualified retirement plan for purposes of determining contributions and benefits, applying the deduction rules, and nondiscrimination testing is limited to $160,000 (for 1999). The compensation limit is indexed for cost-of-living adjustments in $10,000 increments.

A small business may establish a simplified retirement plan called a savings incentive match plan for employees ("SIMPLE") retirement plan. An employer is eligible to adopt a SIMPLE plan if the employer employs 100 or fewer employees who received at least $5,000 in compensation during the preceding year and does not maintain another retirement plan.

A SIMPLE plan may be either an individual retirement arrangement for each employee ("SIMPLE IRA") or part of a qualified cash or deferred arrangement (a "SIMPLE 401(k)"). A SIMPLE IRA is not subject to the nondiscrimination rules or top-heavy rules generally applicable to qualified plans. Similarly, a SIMPLE 401(k) is deemed to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules apply to a SIMPLE 401(k), however.

SIMPLE plans are subject to special contribution rules. Employees may elect during the 60-day period preceding a plan year to make elective contributions under a SIMPLE plan of up to $6,000 during the plan year. The $6,000 dollar limit is adjusted for cost-of-living increases in $500 increments.

An employer that maintains a SIMPLE plan generally is required to match each employee's elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. As an alternative to a matching contribution for any year, an employer may make a nonelective contribution on behalf of each eligible employee equal to 2 percent of the employee's compensation.

Under a SIMPLE-IRA, the compensation limit does not apply for purposes of the required employer matching contribution. If the employer satisfies the contribution requirement by making a nonelective contribution, however, the amount of compensation taken into account for each participant to determine the amount of the required employer contribution may not exceed the compensation limit.

Under a SIMPLE-401(k), the compensation limit applies for purposes of the matching contribution as well as the nonelective contribution.

No contributions other than employee elective contributions and required employer contributions may be made to a SIMPLE plan.

Description of Proposal

The application of the compensation limit would be the same for a SIMPLE-401(k) and a SIMPLE-IRA. Thus, the compensation limit would apply for purposes of the nonelective contribution but not for the matching contribution.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

C. Enhancing Fairness for Women

1. Additional salary reduction catch-up contributions

Present Law[17]

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,000 (for 1999). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,000. These limits are indexed for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,000 (for 1999) or (2) 33-1/3 percent of compensation. The $8,000 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

IRAs[18]

Under present law, individuals may make contributions annually of up to $2,000 to a traditional IRA or a Roth IRA. The maximum deductible contribution to a traditional IRA is phased-out for active participants in an employer-sponsored retirement plan with adjusted gross income above certain levels. The ability to make contributions to a Roth IRA is also phased out above certain income levels.

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[17] The various dollar limits on contributions described below would be increased under other provisions in the proposal.

[18] For a more detailed description of the contribution limits for IRAs, see the discussion of present law in part III.A., above.

Description of Proposal

The proposal would provide that individuals who have attained age 50 would be permitted to make additional catch-up elective contributions to employer-sponsored retirement plans and additional catch-up IRA contributions.

In the case of employer-sponsored retirement plans, the proposal would apply to elective deferrals under a section 401(k) plan, section 403(b) annuity, SIMPLE, or section 457 plan. Additional contributions could be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under the proposal, the additional amount of elective contributions that could be made by an eligible individual participating in such a plan would be the lesser of (1) the applicable percent of the maximum dollar amount of elective deferrals otherwise excludable from the gross income of the participant for the year (under sec. 402(g))or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year.[19] The applicable percent would be 10 percent in 2001, and would increase by 10 percentage points until the applicable percent is 50 in 2005 and thereafter. The following examples illustrate the application of the proposal, after the catch-up is fully phased in.

> <u>Example 1:</u> Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the proposal) is $10,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is $8,000. Under the proposal, A would be able to make additional catch-up salary reduction contributions of $5,000.
>
> <u>Example 2:</u> Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the proposal) is $10,000. Under the terms of the plan, the maximum permitted deferral is 10 percent of compensation or, in B's case, $3,000. Under the proposal, B can contribute up to $8,000 for the year ($3,000 under the normal operation of the plan, and an additional $5,000 under the proposal).

Catch-up contributions made under the proposal would not be subject to any other contribution limits and would not be taken into account in applying other contribution limits. In addition, such contributions would not be subject to applicable nondiscrimination rules.[20]

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[19] In the case of a section 457 plans, this catch-up rule would not apply during the participant's last 3 years before retirement (in those years, the regularly applicable dollar limit is doubled).

[20] Another provision in the proposal would provide that elective contributions are deductible without regard to the otherwise applicable deduction limits.

An employer would be permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions would be subject to the normally applicable rules.

In the case of IRAs, the otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year would be increased by 50 percent.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

2. Equitable treatment for contributions of employees to defined contribution plans

Present Law

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of $30,000 (for 1999) or 25 percent of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local governmental employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,000 (in 1999) or (2) 33-1/3 percent of compensation. The $8,000 limit is increased for inflation in $500 increments.

Description of Proposal

Increase in defined contribution plan limit

The proposal would increase the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent.[21]

Conforming limits on tax-sheltered annuities

The proposal would repeal the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities would be subject to the limits applicable to tax-qualified plans.

Section 457 plans

The proposal would increase the 33-1/3 percent of compensation limitation on deferrals

[21] Another provision of the proposal would increase the defined contribution plan dollar limit.

under a section 457 plan to 100 percent of compensation.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

3. Clarification of tax treatment of division of section 457 plan benefits upon divorce

Present Law

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan ("section 457 plan") of a tax-exempt or State and local government employer. The QDRO rules do not apply to section 457 plans.

Description of Proposal

The proposal would apply the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan would not be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO.

Effective Date

The proposal would be effective for transfers, distributions and payments made after December 31, 2000.

4. Modification of safe harbor relief for hardship withdrawals from 401(k) plans

Present Law

Elective deferrals under a qualified cash or deferred arrangement (a “section 401(k) plan”) may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations[22] provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

Description of Proposal

The Secretary of the Treasury would be directed to revise the applicable regulations to reduce from 12 months to 6 months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

[22] Treas. Reg. sec. 1.401(k)-1.

D. Increasing Portability for Participants

1. Rollovers of retirement plan and IRA distributions

Present Law

In general

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA")[23] or another qualified plan.[24] An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Eligible rollover distributions from a tax-sheltered annuity ("section 403(b) annuity") may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

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[23] A "traditional" IRA refers to IRAs other than Roth IRAs or SIMPLE IRAs. All references to IRAs refers only to traditional IRAs.

[24] An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan.

IRA distributions

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called "conduit IRAs." Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

A "section 457 plan" is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10-percent early withdrawal tax if made before age 59-1/2. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10-percent early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10-percent early withdrawal tax does not apply to section 457 plans.

Description of Proposal

In general

The proposal would provide that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements.[25] Similarly, distributions from an IRA generally could be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules would be extended to distributions from a section 457 plan, and such plans would be required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) would be required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules would apply in certain cases. A distribution from a qualified plan would not be eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan.

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[25] Hardship distributions from governmental section 457 plans would be considered eligible rollover distributions.

Amounts distributed from a section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans would be required to separately account for such amounts. The proposal would also provide that benefits in governmental section 457 plans are includible in income when paid.

Rollover of after-tax contributions

The proposal would provide that employee after-tax contributions could be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover could be accomplished only through a direct rollover. In addition, a qualified plan could not accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) could not be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution would be attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

The proposal would provide that surviving spouses could roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the spouse participates.

Treasury regulations

The Secretary would be directed to prescribe rules necessary to carry out the provisions. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606 - Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date

The proposal would be effective for distributions made after December 31, 2000.

2. Waiver of 60-day rule

Present Law

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement.

Description of Proposal

The proposal would provide that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

Effective Date

The proposal would apply to distributions made after December 31, 2000.

3. Treatment of forms of distribution

Present Law

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)).[26]

The prohibition against the elimination of an optional form of benefit applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. For example, if Plan A, a profit-sharing plan that provides for distribution of benefits in annual installments over ten or twenty years, is merged with Plan B, a profit-sharing plan that provides for distribution of benefits in annual installments over life expectancy at the time of retirement, the merged plan must preserve the ten- or twenty-year installment option with respect to benefits accrued under Plan A as of the date of the merger and the installments over life expectancy with respect to benefits accrued under Plan B as of the date of the merger. Similarly, for example, if a participant's benefit under a defined contribution plan is transferred to another defined contribution plan maintained by the same or a different employer, the optional forms of benefit available with respect to the participant's accrued benefit under the transferor plan must be preserved.[27]

Description of Proposal

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[26] A similar provision is contained in Title I of ERISA.

[27] Treas. Reg. sec. 1.411(d)-4, Q&A-2(a)(3)(i).

A defined contribution plan to which benefits are transferred would not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, (4) if the transferor plan provides for an annuity as the normal form of distribution in accordance with the joint and survivor annuity rules (sec. 417), the participant's spouse (if any) consents to the transfer in a manner similar to the consent required by section 417, and (5) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution.

In addition, except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan would not be treated as reducing a participant's accrued benefit if (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

The Secretary would be directed to issue, not later than December 31, 2001, final regulations under section 411(d)(6) implementing the provisions of the proposal.

Furthermore, the proposal would authorize the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit would not apply to plan amendments that do not adversely affect the rights of participants in a material manner but that do eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants.

It would be intended that the factors to be considered in determining whether an amendment has a materially adverse effect on a participant would include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

<u>**Effective Date**</u>

The proposal would be effective for years beginning after December 31, 2000.

4. Rationalization of restrictions on distributions

Present Law

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), tax-sheltered annuity ("section 403(b) annuity"), or an eligible deferred compensation plan of a tax-exempt organization or State or local government ("section 457 plan"), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include "separation from service."

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.[28]

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but does not experience a separation from service because the employee continues on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary.

Description of Proposal

The proposal would modify the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation's disposition of its assets or a subsidiary would be repealed; this special rule would no longer be necessary under the proposal.

Effective Date

The proposal would be effective for distributions after December 31, 2000.

5. Purchase of service credit under governmental pension plans

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[28] Rev. Rul. 79-336, 1979-2 C.B. 187.

Present Law

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization of a State or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

Description of Proposal

A participant in a State or local governmental plan would not be required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).

Effective Date

The proposal would be effective for transfers after December 31, 2000.

6. Employers may disregard rollovers for purposes of cash-out rules

Present Law

If an qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs 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 a benefit was involuntarily distributed unless the employee repays the benefit.[29]

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.[30]

Description of Proposal

A plan would be permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

Effective Date

The proposal would be effective for distributions after December 31, 2000.

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[29] A similar provision is contained in Title I of ERISA.

[30] Other provisions of the proposal would expand the kinds of plans to which benefits may be rolled over.

E. Strengthening Pension Security And Enforcement

1. Phase in repeal of 150 percent of current liability funding limit; deduction for contributions to fund termination liability

Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 155 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)).[31] In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.[32] In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Description of Proposal

Current liability full funding limit

The proposal would gradually increase and then repeal the current liability full funding limit. The current liability full funding limit would be 160 percent of current liability for plan years beginning in 2001, 165 percent for plan years beginning in 2002, and 170 percent for plan years

[31] The minimum funding requirements, including the full funding limit, are also contained in title I of ERISA.

[32] As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, and adopted the scheduled increases described in the text.

beginning in 2003. The current liability full funding limit would be repealed for plan years beginning in 2004 and thereafter.

Deduction for contributions to fund termination liability

Under the proposal, the special rule allowing a deduction for unfunded current liability generally would be extended to all defined benefit pension plans, i.e., the provision would apply to multiemployer plans and plans with 100 or fewer participants. The special rule would not apply to plans not covered by the PBGC termination insurance program.[33]

The proposal would also modify the rule by providing that the deduction is for up to 100 percent of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability would not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years.

Effective Date

The proposals would be effective for years beginning after December 31, 2000.

2. Extension of PBGC missing participants program

Present Law

The plan administrator of a defined benefit pension plan that is subject to Title IV of ERISA, is maintained by a single employer, and terminates under a standard termination is required to distribute the assets of the plan. With respect to a participant whom the plan administrator cannot locate after a diligent search, the plan administrator satisfies the distribution requirement only by purchasing irrevocable commitments from an insurer to provide all benefit liabilities under the plan or transferring the participant's designated benefit to the Pension Benefit Guaranty Corporation ("PBGC"), which holds the benefit of the missing participant as trustee until the PBGC locates the missing participant and distributes the benefit.

The PBGC missing participant program is not available to multiemployer plans or defined contribution plans and other plans not covered by Title IV of ERISA.

Description of Proposal

[33] The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

The proposal would direct the PBGC to prescribe for terminating multiemployer plans rules similar to the present-law missing participant rules applicable to terminating single employer plans that are subject to Title IV of ERISA.

Effective Date

The proposal would be effective for distributions from terminating plans that occur after the PBGC has adopted final regulations implementing the proposal.

3. Repeal 100 percent of compensation limit for defined benefit multiemployer plans

Present Law

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415). The limits on contributions and benefits under qualified plans are based on the type of plan.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of average compensation for the highest three years, or (2) $130,000 (for 1999). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age.

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is $75,000.

In the case of a defined contribution plan, the limit on annual is additions if the lesser of (1) 25 percent of compensation[34] or (2) $30,000 (for 1999). In applying the limits on contributions and benefits, plans of the same employer are aggregated.

Description of Proposal

Under the proposal, the 100 percent of compensation defined benefit plan limit would not apply to multiemployer plans. In addition, except in applying the defined benefit plan dollar limitation, multiemployer plans would not be aggregated with other plans maintained by an employer contributing to the multiemployer plan in applying the limits on contributions and benefits.

The proposal would also apply the special rules for defined benefit plans of governmental employers to multiemployer plans.

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[34] Another provision of the proposal would increase this limit to 100 percent of compensation.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

4. Excise tax relief for sound pension funding

Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 155 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.[35] In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year. The 10-percent excise tax does not apply to contributions to certain terminating defined benefit plans. The 10-percent excise tax also does not apply to contributions of up to 6 percent of compensation to a defined contribution plan for employer matching and employee elective deferrals.

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[35] As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, and adopted the scheduled increases described in the text.

Description of Proposal

Under the proposal, in determining the amount of nondeductible contributions, the employer could elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit would not be subject to the excise tax on nondeductible contributions. An employer making such an election for a year could not take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

5. Notice of significant reduction in plan benefit accruals

Present Law

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice ("section 204(h) notice"), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations[36] provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required

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[36] Treas. Reg. sec. 1.411(d)-6.

to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

The Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

Description of Proposal

The proposal would add to the Internal Revenue Code a requirement that the plan administrator of a defined benefit pension plan furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy.[37] The notice would be required to set forth the plan amendment and its effective date and provide sufficient information (as defined in Treasury regulations) to allow participants to understand how the amendment generally would affect different classes of employees. The plan administrator would be required to provide the notice not less than 30 days before the effective date of the plan amendment.

The plan administrator would be required to provide this notice to each participant and alternate payee to whom the amendment applies, and to each employee organization representing such individuals. The plan administrator would not be required to provide this notice to any participant who has less than 1 year of participation in the plan or who is entitled to receive the greater of the participant's accrued benefit under the amended plan formula or under the formula as in effect immediately prior to the amendment effective date.

If the amendment would provide for a significant change in the manner in which accrued benefits are determined under the plan, or would require an affected participant or affected alternate payee to choose between 2 or more benefit formulas, the plan administrator would be required to provide an additional notice to each affected participant and affected alternate payee within 6 months after the effective date of the amendment. For purposes of the proposal, an affected participant or alternate payee generally would be a participant or alternate payee to whom the significant reduction in the rate of future benefit accrual would be reasonably expected to apply. A participant who has less than 1 year of participation in the plan, or who is entitled to receive the greater of the participant's accrued benefit under the amended plan formula or under the formula as in effect immediately prior to the amendment effective date, would not be an affected participant.

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[37] The proposal also would modify the present-law notice requirement contained in section 204(h) of Title I of ERISA to provide that an applicable pension plan may not be amended to provide for a significant reduction in the rate of future benefit accrual unless the plan administrator complies with a notice requirement similar to the notice requirement that the proposal would add to the Internal Revenue Code.

The plan administrator would be required to provide in this additional notice (1) the individual's accrued benefit (and if the amendment would add the option of an immediate lump sum distribution, the present value of the accrued benefit) as of the amendment effective date, determined under the terms of the plan in effect immediately before the effective date, (2) the individual's accrued benefit as of the amendment effective date, determined under the terms of the plan in effect on the amendment effective date and without regard to any minimum accrued benefit that may not be decreased by the amendment (sec. 411(d)(6)), and (3) either (a) sufficient information (as defined in Treasury regulations) for the individual to compute his or her projected accrued benefit or to acquire information necessary to compute such projected accrued benefit, or (b) a determination of the individual's projected accrued benefit with a disclosure of the assumptions (which must be reasonable in the aggregate) used by the plan in determining the projected accrued benefit. For purposes of this additional notice, an individual's accrued benefit and projected accrued benefit would be computed as if the accrued benefit were in the form of a single life annuity at normal retirement age, taking into account any early retirement subsidy.

With respect to a plan amendment that would require a participant or alternate payee to choose between 2 or more benefit formulas, the Secretary of the Treasury, after consultation with the Secretary of Labor, would be authorized to require additional information to be provided in the notices and to require either of the notices to be provided at a different time.

The proposal generally would impose on a plan administrator that fails to comply with the notice requirement an excise tax equal to $100 per day per omitted participant and alternate payee. For failures due to reasonable cause and not to willful neglect, the total excise tax imposed during a taxable year of the employer would not exceed $500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

Effective Date

The proposal would be effective for plan amendments taking effect on or after the date of enactment with a delayed effective date for a plan maintained pursuant to a collective bargaining agreement. The period for providing any notice required under the proposal would not end before the last day of the 3-month period following the date of enactment. Prior to the issuance of Treasury regulations, a plan would be treated as meeting the requirements of the proposal if the plan makes a good faith effort to comply with such requirements.

6. Investment of employee contributions in 401(k) plans

Present Law

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10 percent of the fair market value of plan assets. The 10-percent limitation does not apply to any "eligible individual account plans" that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement ("401(k) plans").

The term "eligible individual account plan" does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1 percent of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10-percent limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10 percent of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10 percent of the value of the assets of all pension plans maintained by the employer. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

Description of Proposal

The proposal would modify the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

Effective Date

The proposal would be effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

F. Encouraging Retirement Education

1. Periodic pension benefit statements

Present Law

Title I of ERISA provides that a pension plan administrator must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. This statement must indicate, on the basis of the latest available information, (1) the participant's or beneficiary's total accrued benefit, and (2) the participant's or beneficiary's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than 1 benefit statement during any 12-month period. The plan administrator must furnish the benefit statement no later than 60 days after receipt of the request or, if later, 120 days after the close of the immediately preceding plan year.

In addition, the plan administrator must furnish a benefit statement to each participant whose employment terminates or who has a 1-year break in service. For purposes of this benefit statement requirement, a "1-year break in service" is a calendar year, plan year, or other 12-month period designated by the plan during which the participant does not complete more than 500 hours of service for the employer. A participant is not entitled to receive more than 1 benefit statement with respect to consecutive breaks in service. The plan administrator must provide a benefit statement required upon termination of employment or a break in service no later than 180 days after the end of the plan year in which the termination of employment or break in service occurs.

Description of Proposal

A plan administrator of a defined contribution plan generally would be required to furnish a benefit statement to each participant at least once annually and to a beneficiary upon written request.

In addition to providing a benefit statement to a beneficiary upon written request, the plan administrator of a defined benefit plan generally would be required either (1) to furnish a benefit statement at least once every 3 years to each participant who has a vested accrued benefit and who is employed by the employer at the time the plan administrator furnishes the benefit statements to participants, or (2) to annually furnish written, electronic, telephonic, or other appropriate notice to each participant of the availability of and the manner in which the participant may obtain the benefit statement.

The plan administrator of a multiemployer plan or a multiple employer plan would be required to furnish a benefit statement only upon written request of a participant or beneficiary.[38]

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[38] A multiple employer plan is a plan that is maintained by 2 or more unrelated employers but that is not maintained pursuant to a collective-bargaining agreement (sec. 413(c)).

The plan administrator would be required to write the benefit statement in a manner calculated to be understood by the average plan participant and would be permitted to furnish the statement in written, electronic, telephonic, or other appropriate form.

Effective Date

The proposal would be effective for plan years beginning after December 31, 2000.

2. Treatment of employer-provided retirement advice

Present Law

Under present law, certain employer-provided fringe benefits are excludable from gross income (sec. 132) and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable.

In addition, if certain requirements are satisfied, up to $5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after May 31, 2000.[39] Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

Description of Proposal

The proposal would provide that qualified retirement planning services provided to an employee and his or her spouse are excludable from income and wages. The exclusion would not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's pension plan. The exclusion would not be limited to information regarding the plan but would include, for example, information regarding how the plan relates to retirement income planning as a whole.

Effective Date

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[39] The exclusion does not apply with respect to graduate-level courses.

The proposal would be effective with respect to taxable years beginning after December 31, 2000.

G. Reducing Regulatory Burdens

1. Flexibility in nondiscrimination and coverage rules

Present Law

A plan is not a qualified retirement plan if the contributions or benefits provided under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The applicable Treasury regulations set forth the exclusive rules for determining whether a plan satisfies the nondiscrimination requirement. These regulations state that the form of the plan and the effect of the plan in operation determine whether the plan is nondiscriminatory and that intent is irrelevant. Prior to 1994, a plan's compliance with the nondiscrimination rules was based upon the facts and circumstances surrounding the design and operation of the plan.

Similarly, a plan is not a qualified retirement plan if the plan does not benefit a minimum number of employees (sec. 410(b)). A plan satisfies this minimum coverage requirement if and only if it satisfies one of the tests specified in the applicable Treasury regulations. Prior to 1989, a plan's compliance with the coverage rules was based partially on the facts and circumstances surrounding the design of the plan.

Description of Proposal

The Secretary of the Treasury would be directed to provide by regulation applicable to years beginning after December 31, 2000, that a plan would be deemed to satisfy the nondiscrimination requirements of section 401(a)(4) if the plan satisfies the pre-1994 facts and circumstances test, satisfies the conditions prescribed by the Secretary to appropriately limit the availability of such test, and is submitted to the Secretary for a determination of whether it satisfies such test (to the extent provided by the Secretary).

Similarly, a plan would comply with the minimum coverage requirement of section 410(b) if the plan satisfies the pre-1989 coverage rules, is submitted to the Secretary for a determination of whether it satisfies the pre-1989 coverage rules (to the extent provided by the Secretary), and satisfies conditions prescribed by the Secretary by regulation that appropriately limit the availability of the pre-1989 coverage rules.

Effective Date

The proposal would be effective for years beginning after December 31, 2000. Any condition of availability prescribed by the Secretary to appropriately limit the availability of flexibility in the nondiscrimination and coverage rules would not apply before the first year beginning not less than 120 days after the date on which such condition is prescribed.

2. Modification of timing of plan valuations

Present Law

Under present law, in the case of plans subject to the minimum funding rules, a plan valuation is generally required annually. The Secretary may require that a valuation be made more frequently in particular cases.

Prior to the Retirement Protection Act of 1994, plan valuations generally were required at least once every three years.

Description of Proposal

The proposal would allow an employer to elect to use the prior year's plan valuation in certain cases. The election could be made only with respect to a defined benefit plan with assets of at least 125 percent of current liability (determined as of the valuation date for the preceding year). If the prior year's valuation is used, it would have to be adjusted, as provided in regulations, to reflect significant differences in participants. An election made under the proposal could be revoked only with the consent of the Secretary. In any event, a plan valuation would be required once every three years.[40]

Effective Date

The proposal would be effective for plan years beginning after December 31, 2000.

3. Rules for substantial owner benefits in terminated plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees as to the receipt of benefits under the plan in case of plan termination. The employer sponsoring the defined benefit pension plan is required to pay premiums to the PBGC to provide insurance for the guaranteed benefits. In general, the PBGC will guarantee all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. The amount of the guaranteed benefit is subject to certain limitations. One limitation is that the plan (or an amendment to the plan which increases benefits) must be in effect for 60 months before termination for the PBGC to guarantee the full amount of basic benefits for a plan participant, other than a substantial owner. In the case of a substantial owner, the guaranteed basic benefit is phased in over 30 years beginning with participation in the plan. A substantial owner is one who owns, directly or indirectly, more than 10

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[40] As under present law, the Secretary could require that a valuation be made more frequently in particular cases.

percent of the voting stock of a corporation or all the stock of a corporation. Special rules restricting the amount of benefit guaranteed and the allocation of assets also apply to substantial owners.

Description of Proposal

The proposal would provide that the 60 month phase-in of guaranteed benefits would apply to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest ("majority owner"), the phase-in would depend on the number of years the plan has been in effect. The majority owner's guaranteed benefit would be limited so that it could not be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets would apply to substantial owners, other than majority owners, in the same manner as other participants.

Effective Date

The proposal would be effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC after December 31, 2000.

4. ESOP dividends may be reinvested without loss of dividend deduction

Present Law

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

Description of Proposal

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer would be entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

5. Notice and consent period regarding distributions

Present Law

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements (sec. 417) apply to the participant.[41]

If the present value of the participant's vested accrued benefit exceeds $5,000, the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (3) the rules concerning the taxation of a distribution. If the joint and survivor annuity requirements apply to the participant, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

If the participant's vested accrued benefit does not exceed $5,000, the terms of the plan may provide for distribution without the participant's consent. The plan generally is required, however, to provide to the participant a notice that contains a written explanation of (1) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (2) the rules concerning the taxation of a distribution. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

Description of Proposal

A qualified retirement plan would be required to provide the applicable distribution notice no less than 30 days and no more than 12 months before the date distribution commences. The Secretary of the Treasury would be directed to modify the applicable regulations to reflect the extension of the notice period to 12 months and to provide that the description of a participant's

[41] Similar provisions are contained in Title I of ERISA.

right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

Effective Date

The proposal would be effective for years beginning after December 31, 2000.

6. Repeal transition rule relating to certain highly compensated employees

Present Law

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee[42] who (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $80,000 (for 1999) or (b) at the election of the employer, had compensation in excess of $80,000 for the preceding year and was in the top 20 percent of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

Description of Proposal

The proposal would repeal the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition would apply.

Effective Date

The proposal would be effective for plan years beginning after December 31, 1999.

7. Employees of tax-exempt entities

Present Law

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement ("section 401(k) plan"). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

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[42] An employee includes a self-employed individual.

Treasury regulations provide that, for purposes of nondiscrimination testing under section 410(b), a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan, the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees could be disregarded only if more than 95 percent of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.[43]

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a "section 403(b) annuity") that allows employees to make salary reduction contributions.

Description of Proposal

The proposal would direct the Treasury Department to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) more than 95 percent of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

Effective Date

The proposal would be effective on the date of enactment.

8. Provisions relating to plan amendments

Present Law

Plan amendments to reflect amendments to the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs.

Description of Proposal

Any amendments to a plan or annuity contract required to be made by the proposal would not be required to be made before the last day of the first plan year beginning on or after January 1, 2003. In the case of a governmental plan, the date for amendments would be extended to the first plan year beginning on or after January 1, 2005.

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[43] Treas. Reg. sec. 1.410(b)-6(g).

Effective Date

The provision would be effective on the date of enactment.

9. Extension to international organizations of moratorium on application of certain nondiscrimination rules applicable to State and local government plans

Present Law

A qualified retirement plan maintained by a State or local government is exempt from the rules concerning nondiscrimination (sec. 401(a)(4)) and minimum participation (sec. 401(a)(26)). A governmental plan maintained by an international organization that is exempt from taxation by reason of the International Organizations Immunities Act is not exempt from the nondiscrimination and minimum participation rules.

Description of Proposal

A governmental plan maintained by a tax-exempt international organization would be exempt from the nondiscrimination and minimum participation rules.

Effective Date

The proposal would be effective for plan years beginning after December 31, 2000.

10. Annual report dissemination

Present Law

Title I of ERISA generally requires the plan administrator of each employee pension benefit plan and each employee welfare benefit plan to file an annual report concerning the plan with the Secretary of Labor within 7 months after the end of the plan year. Within 9 months after the end of the plan year, the plan administrator generally must provide to each participant, and to each beneficiary receiving benefits under the plan, a summary of the annual report filed with the Secretary of Labor for the plan year.

Description of Proposal

Within 9 months after the end of each plan year, the plan administrator would be required to make available for examination a summary of the annual report filed with the Secretary of Labor for the plan year. In addition, the plan administrator would be required to furnish the summary to a participant, or to a beneficiary receiving benefits under the plan, upon request.

Effective Date

The proposal would be effective for reports for years beginning after December 31, 1998.

11. Clarification of exclusion for employer-provided transit passes

Present Law

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income and wages. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. Up to $175 per month (for 1999) of employer-provided parking is excludable from income and up to $65 (for 1999) per month of employer-provided transit and vanpool benefits are excludable from income.

Qualified transportation benefits generally include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

No amount is includible in the gross income of an employee merely because the employee is offered a choice between cash and any qualified transportation benefit (or a choice among such benefits).

Description of Proposal

The proposal would repeal the rule providing that cash reimbursements for transit benefits are excludable from income only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

IV. EDUCATION TAX RELIEF

A. Eliminate Marriage Penalty and 60-Month Limit on Student Loan Interest Deduction

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (sec. 221). The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable deduction per taxpayer return is $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter.[44] The deduction is phased out ratably for individual taxpayers with modified adjusted gross income of $40,000-$55,000 and $60,000-$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would increase the beginning point of the income phaseout for the student loan interest deduction for individual taxpayers from $40,000 to $50,000. For taxpayers filing joint returns, the proposal would increase the beginning point of the income phaseout to twice the beginning point of the income phaseouts applicable to single taxpayers. Thus, beginning in 2000, the deduction would be phased out ratably for individual taxpayers with modified adjusted gross income of $50,000-$65,000 and for taxpayers filing joint returns with modified adjusted gross income of $100,000-$115,000.

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[44] The maximum allowable deduction for 1998 was $1,000.

The proposal also would repeal both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that nonmandatory payments of interest are not deductible.

Effective Date

The proposal would be effective generally for taxable years beginning after December 31, 1999. The proposal repealing the 60-month limit on deductible student loan interest would be effective for interest paid on qualified education loans after December 31, 1999.

B. Allow Tax-free Distributions From State and Private Education Programs

Present Law

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a 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 (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution[45], as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is 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) are 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) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.[46]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.[47] Contributors and beneficiaries are not allowed to directly or indirectly direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as

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[45] "Eligible educational institutions" are defined the same for purposes of education IRAs (described in II.1., above) and qualified State tuition programs.

[46] Distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

[47] Sections 529(c)(2), (c)(4), and (c)(5), and section 530(d)(3) provide special estate and gift tax rules for contributions made to, and distributions made from, qualified State tuition programs and education IRAs.

scholarships. A transfer of credits (or other amounts) from one account benefitting one designated beneficiary to another account benefitting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws--and any spouse of such persons or of the original beneficiary. Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the distributee (or another taxpayer claiming the distributee as a dependent) may claim the HOPE credit or Lifetime Learning credit under section 25A with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

Description of Proposal

Qualified tuition program

The proposal would expand the definition of “qualified tuition program” to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary as set forth in section 529(b)(1)(A)(i), but would not be able to make contributions to an account described in section 529(b)(1)(A)(ii) (so-called “savings account plans”).

Exclusion from gross income

Under the proposal, an exclusion from gross income would be provided for distributions made in taxable years beginning after December 31, 1999, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income would be extended to distributions from qualified tuition programs established and maintained by an entity other than a State or agency or instrumentality thereof, for distributions made in taxable years after December 31, 2003.

Coordination of education provisions

The proposal also would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program and/or an education individual retirement account on behalf of the same student as long as the distributions are not used for the same expenses for which a credit was claimed.

Definition of qualified higher education expenses

Under the proposal, the definition of "qualified higher education expenses" would be modified to mean: (1) tuition and fees required for the enrollment or attendance of a designated beneficiary at an eligible education institution; and (2) expenses for books, supplies, and equipment incurred in connection with such enrollment or attendance (but not in excess of the allowance for books and supplies determined by the educational institution for purposes of federal financial assistance programs). The proposal also would provide that "qualified higher education expenses" shall not include expenses for education involving sports, games, or hobbies unless this education is part of the student's degree program or is taken to acquire or improve job skills of the individual. The proposal would not change the definition of "qualified higher education expenses" with respect to expenses for room and board.

Rollovers for benefit of same beneficiary

The proposal would clarify that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary will not be considered a distribution for a maximum of one such transfer in each 1-year period.

Member of family

The proposal would provide that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of such beneficiary.

Effective Date

The proposal permitting the establishment of qualified tuition programs maintained by one or more private educational institutions would be effective for taxable years beginning after December 31, 1999. The exclusion from gross income for certain distributions from qualified State tuition programs under section 529 would be effective for distributions made in taxable years beginning after December 31, 1999. In the case of a qualified tuition program established and maintained by an entity other than a State or agency or instrumentality thereof, the proposal allowing an exclusion from gross income for certain distributions would be effective for distributions made in taxable years beginning after December 31, 2003. The proposal coordinating distributions from qualified tuition programs and education individual retirement accounts with the HOPE and Lifetime Learning credits would be effective for distributions made after December 31, 1999. The proposal modifying the definition of qualified higher education expenses is effective for amounts paid for education furnished after December 31, 1999. The provisions allowing rollovers for the same beneficiary and including first cousins as a member of the family would be effective for taxable years beginning after December 31, 1999.

C. Eliminate Tax on Awards Under National Health Service Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

Present Law

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. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

Section 117(c) specifically provides that the exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health-care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients of scholarships in both of these programs are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Description of Proposal

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program would be eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment would not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The proposal would be effective for education awards received under the NHSC Scholarship Program and the Armed Forces Scholarship Program after December 31, 1993.

D. Exclusion for Employer-Provided Educational Assistance

Present Law

Educational expenses paid by an employer for its employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses. The exclusion for employer-provided educational assistance expires with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, 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 plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[48] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (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, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally 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.[49]

[48] These rules also apply in the event that section 127 expires and is not reinstated.

[49] 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, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

Description of Proposal

The proposal would make the exclusion for employer-provided educational assistance permanent. The proposal would also extend the exclusion to graduate education, effective for courses beginning on or after January 1, 2000.

Effective Date

The provision would generally be effective with respect to educational assistance provided after May 30, 2000. The exclusion with respect to graduate-level courses would be effective for courses beginning on or after January 1, 2000.

E. Liberalize Tax-Exempt Financing Rules for Public School Construction

Present Law

Tax-exempt bonds

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out and paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

The Code includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Businesses eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Finally, tax-exempt private activity bonds may be issued to finance limited non-business purposes: student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

In most cases, the volume of tax-exempt private activity bonds is restricted by aggregate annual limits imposed on bonds issued by issuers within each State. These annual volume limits equal $50 per resident of the State, or $150 million if greater. The annual State private activity bond volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2007. The increase will be phased in ratably beginning in calendar year 2003. This increase was enacted by the Tax and Trade Relief Extension Act of 1998. Qualified 501(c)(3) bonds are among the tax-exempt private activity bonds that are not subject to these volume limits.

Private activity tax-exempt bonds may not be used to finance schools owned or operated by private, for-profit businesses.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

The Code includes three exceptions applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public schools) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months for construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.

Restriction on Federal guarantees of tax-exempt bonds

Unlike interest on State or local government bonds, interest on Federal debt (e.g., Treasury bills) is taxable. Generally, interest on State and local government bonds that are Federally guaranteed does not qualify for tax-exemption. This restriction was enacted in 1984. The 1984 legislation included exceptions for housing bonds and for certain Federal insurance programs that were in existence when the restriction was enacted.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue "qualified zone academy bonds." Under present law, a total of $400 million of qualified zone academy bonds may be issued in each of 1998 and 1999. The $400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation into subsequent years.

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set monthly by Treasury Department regulation at 110 percent of the applicable Federal rate for the month in which the bond is issued) multiplied by the face amount of the bond (sec. 1397E). The credit rate applies to all such bonds issued in each month. A taxpayer holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and credit may be claimed against regular income tax and alternative minimum tax liability.

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

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

Description of Proposals

Increase amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirement would be increased from $5 million to $10 million. Thus, these governmental units could issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds were used for public schools.

Allow issuance of tax-exempt private activity bonds for public school facilities

The private activities for which tax-exempt bonds may be issued would be expanded to include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The school facilities for which these bonds were issued would be required to be operated by a public educational agency as part of a system of public schools. Issuance of these bonds would be subject to an annual per-State volume limit equal to the greater of $10 per resident ($5 million, if greater) in lieu of the present-law State private activity bond volume limits.

Permit limited Federal guarantees of school construction bonds by the Federal Housing Finance Board

The Federal Housing Finance Board would be permitted to guarantee (through the 12 regional Federal Home Loan Banks in its system) up to $500 million per year of governmental bonds 95 percent of more of the proceeds of which are used for public school construction.

Effective Dates

The proposals would be effective for bonds issued after December 31, 1999.

V. HEALTH CARE TAX RELIEF PROVISIONS

A. Above-the-Line Deduction for Health Insurance Expenses

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001; 70 percent in 2002; and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction applies to qualified long-term care insurance premiums treated as medical expenses under the itemized deduction for medical expenses, described below.

Employees can exclude from income 100 percent of employer-provided health insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 is as follows: $210 in the case of an individual 40 years old or less; $400 in the case of an individual who is more than 40 but not more than 50; $800 in the case of an individual who is more than 50 but not more than 60; $2,120 in the case of an individual who is more than 60 but not more than 70; and $2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Description of Proposal

The proposal would provide an above-the-line deduction for a percentage of the amount paid during the year for insurance which constitutes medical care (as defined under sec. 213, other than long-term care insurance treated as medical care under sec. 213) for the taxpayer and his or her spouse and dependents.[50] The deductible percentage would be: 25 percent in 2001 through 2003; 50 percent in 2004 through 2005; and 100 percent in 2006 and thereafter.

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[50] The deduction would only apply to health insurance that constitutes medical care; it would not apply to medical expenses. The deduction would apply to self-insured arrangements (provided such arrangements constitute insurance, e.g., there is appropriate risk-shifting) and coverage under employer plans treated as insurance under section 104. Another provision of the proposal would provide a similar deduction for qualified long-term care insurance expenses.

The deduction would not be available to an individual for any month in which the individual is covered under an employer-sponsored health plan if the at least 50 percent of the cost of the coverage is paid or incurred by the employer.[51] For purposes of this rule, any amounts amounts excludable from the gross income of the employee under the exclusion for employer-provided health coverage would be treated as paid or incurred by the employer; thus, for example, health insurance purchased by an employee through a cafeteria plan with salary reduction amounts would be considered to be paid for by the employer.[52] In determining whether the 50-percent threshold is met, all health plans of the employer in which the employee participates would be treated as a single plan. If the employer pays for less than 50 percent of the cost of all health plans in which the individual participates, the deduction would be available only with respect to each plan with respect to which the employer subsidy is less than 50 percent. Cost would be determined as under the health care continuation rules. The following examples illustrate the application of the 50-percent rule.

Example 1: Employee A participates in an employer-sponsored health plan. The annual cost for single coverage is $3,000, and the annual additional cost for coverage for A's spouse and dependents is $1,000. The employer pays 100 percent of the cost of individual coverage, but does not pay any additional amount for family coverage. A chooses family coverage. The total amount the employer pays for the insurance is $3,000, which is 75 percent of the total cost of the coverage ($4,000). Thus, the deduction would not be available.

Example 2: Employee B participates in two employer-sponsored health plans. One plan provides major medical coverage. The cost of this plan is $2,000 per year. The employer pays for half the cost of this plan ($1,000). The second plan provides only dental coverage. The cost of the dental plan is $300 per year, which is paid by the employee. The total cost of the health plans in which B participates is $2,300. The employer pays for less than 50 percent of this total cost. B may deduct the cost of the dental coverage; but not B's share of the premium for the major medical plan, because the employer pays for at least 50 percent of the cost of that plan.

The deduction would not be available to individuals enrolled in Medicare, Medicaid, the Federal Employees Benefit Program,[53] Champus, VA, Indian Health Service, or Children's Health Insurance programs.

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[51] This rule would be applied separately with respect to qualified long-term care insurance.

[52] Excludable employer contributions to a health flexible spending arrangement or medical savings account (including salary reduction contributions) would also be considered amounts paid by the employer for health insurance that constitutes medical care.

[53] The deduction would be available with respect to premiums for health care continuation coverage, provided the requirements for the deduction are otherwise met.

Under the proposal, employers would be required to report information regarding employee health care coverage, such as whether the employee is covered under a health insurance or long-term care insurance plan, and the total cost of such coverage.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

B. Provisions Relating to Long-term Care Insurance

Present Law

Tax treatment of health insurance and long-term care insurance

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001; 70 percent in 2002; and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction applies to qualified long-term care insurance premiums treated as medical expenses under the itemized deduction for medical expenses, described below.

Employees can exclude from income 100 percent of employer-provided health insurance or qualified long-term care insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 is as follows: $210 in the case of an individual 40 years old or less; $400 in the case of an individual who is more than 40 but not more than 50; $800 in the case of an individual who is more than 50 but not more than 60; $2,120 in the case of an individual who is more than 60 but not more than 70; and $2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Cafeteria plans

Under present law, compensation generally is includible in gross income when actually or constructively received. An amount is constructively received by an individual if it is made available to the individual or the individual has an election to receive such amount. Under one exception to the general principle of constructive receipt, amounts are not included in the gross income of a participant in a cafeteria plan described in section 125 of the Code solely because the participant may elect among cash and certain employer-provided qualified benefits under the plan. This constructive receipt exception is not available if the individual is permitted to revoke a benefit election during a period of coverage in the absence of a change in family status or certain other events.

In general, qualified benefits are certain specified benefits that are excludable from an employee's gross income by reason of a specific provision of the Code. Thus, employer-provided accident or health coverage, group-term life insurance coverage (whether or not subject to tax by reason of being in excess of the dollar limit on the exclusion for such insurance), and benefits under dependent care assistance programs may be provided through a cafeteria plan. The cafeteria plan exception from the principle of constructive receipt generally also applies for employment tax (FICA and FUTA) purposes.[54]

Long-term care insurance cannot be provided under a cafeteria plan.

Flexible spending arrangements

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employer pays or reimburses employees for medical expenses or certain other nontaxable employer-provided benefits, such as dependent care. An FSA may be part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance. Qualified long-term care services cannot be provided through an FSA.

Description of Proposal

Deduction for qualified long-term care insurance expenses

The proposal would provide an above-the-line deduction for a percentage of the amount paid during the year for long-term care insurance which constitutes medical care (as defined under sec. 213) for the taxpayer and his or her spouse and dependents.[55] The deductible percentage would be: 25 percent in 2001 through 2003; 50 percent in 2004 through 2005; and 100 percent in 2006 and thereafter.

The deduction would not be available to an individual for any month in which the individual is covered under an employer-sponsored health plan if at least 50 percent of the cost of the coverage is paid or incurred by the employer.[56] For purposes of this rule, an employer any amounts excludable from the gross income of the employee with respect to qualified long-term care insurance would be treated as paid or incurred by the employer. In determining whether the 50-

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[54] Elective contributions under a qualified cash or deferred arrangement that is part of a cafeteria plan are subject to employment taxes.

[55] The deduction would only apply to insurance that constitutes medical care; it would not apply to long-term care insurance expenses. The deduction would apply to self-insured arrangements (provided such arrangements constitute insurance, e.g., there is appropriate risk-shifting) and coverage under employer plans treated as insurance under section 104. Another provision of the proposal would provide a similar deduction for health insurance expenses.

[56] This rule would be applied separately with respect to health insurance.

percent threshold is met, all plans of the employer providing long-term care in which the employee participates would be treated as a single plan. If the employer pays less than 50 percent of the cost of all long-term care plans in which the individual participates, the deduction would be available only with respect to each plan with respect to which the employer pays for less than 50 percent of the cost. Cost would be determined as under the health care continuation rules.

Under the proposal, employers would be required to report information regarding employee health care coverage, such as whether the employee is covered under a health insurance or long-term care insurance plan, and the total cost of such coverage.

The proposal would provide that qualified long-term care insurance is a qualified benefit under a cafeteria plan. The proposal would also provide that qualified long-term care services can be provided under an FSA.[57]

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

[57] Excludable employer contributions to a flexible spending arrangement or a cafeteria plan for qualified long-term care insurance or services would be considered an amount paid by the employer for long-term care insurance.

C. Additional Personal Exemption for Caretakers

Present Law

Generally, present law does not provide for an additional personal exemption based solely on the custodial care of parents or grandparents. However, taxpayers with dependent parents generally are able to claim a personal exemption for each of these dependents, if they satisfy five tests: (1) a member of household or relationship test; (2) a citizen test; (3) a joint return test; (4) a gross income test; and (5) a support test. The taxpayer is also required to list each dependent's tax identification number (the TIN") on the tax return.

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 $2,750 for 1999, and is adjusted annually for inflation. The total amount of the personal exemptions is phased out for taxpayers with AGI in excess of $126,600 for single taxpayers, $158,300 for heads of household, and $189,950 for married couples filing joint returns. For 1999, the point at which a taxpayer's personal exemptions are completely phased-out is $249,100 for single taxpayers, $280,800 for heads of households, and $312,450 for married couples filing joint returns.

Description of Proposal

The proposal would provide taxpayers who maintain a household including one or more "qualified persons" with an additional personal exemption in computing income tax liability for each qualified person.

To be a "qualified person," an individual would have to satisfy: (1) a relationship test, (2) a residency test, (3) a disability test, and (4) an identification test. The individual would satisfy the relationship test if the individual was the father or mother of: (a) the taxpayer, (b) the taxpayer's spouse, or (c) a former spouse of the taxpayer. A stepfather, stepmother, and ancestors of the father or mother would be treated as a father or mother for these purposes.

An individual would satisfy the residency test if the individual had the same principal place of abode as the taxpayer for the taxpayer's entire taxable year.

An individual would satisfy the disability test if the individual was certified before the due date of the return for the taxable year (without extensions) by a licensed physician as being unable for period of at least 180 consecutive days to perform at least 2 activities of daily living ("ADLs") without substantial assistance from another individual, due to a loss of functional capacity. As with the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include hands-on assistance (that is, the physical assistance of another person without which the individual is unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

As an alternative to the 2-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as (a) requiring substantial supervision for at least 6 months to be protected from threats to health and safety due to severe cognitive impairment and (b) being unable for at least 6 months to perform at least one or more ADLs or to engage in age appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

An individual would satisfy the identification test if the individual's name and taxpayer identification number (TIN) were included on the taxpayer's return for the taxable year.

The proposal would provide that a taxpayer is treated as maintaining a household for any period only if over one-half of the cost of maintaining a household for such period is furnished by such taxpayer or, if such taxpayer is married, by such taxpayer and the taxpayer's spouse. The proposal would also provide that taxpayers who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart from their respective spouse for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualified person for the entire taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Finally, the proposal would provide that a taxpayer legally separated from the taxpayer's spouse under a decree of divorce or of separate maintenance would not be considered married for purposes of this provision.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

D. Add Certain Vaccines Against Streptococcus Pneumoniae to the List of Taxable Vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. The tax applies to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the 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, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would add conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines. The proposal also would change the effective date enacted in Public Law 105-277 and certain other conforming amendments to expenditure purposes to enable certain payments to be made from the Trust Fund.

The proposal also would reduce the rate of tax applicable to all taxable vaccines from 75 cents per dose to 25 cents per dose for sales of vaccines after December 31, 2004.

In addition, the General Accounting Office ("GAO") would be directed to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation and management of expenditures from the Vaccine Injury Compensation Trust Fund and to advise the Committees on the adequacy of the Vaccine Injury Compensation Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program. The GAO would report its findings to the House Committee on Ways and Means and the Senate Committee on Finance within one year from the date of enactment.

Effective Date

The proposal to include conjugate streptococcus pneumoniae vaccines would be effective for vaccine purchases beginning on the day after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugated streptococcus pneumoniae vaccines to children. No floor stocks tax would be collected for amounts held for sale on that date.

The addition of conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines would be contingent upon the inclusion in this legislation of the modifications to Public Law 105-277.

The proposal to reduce the rate of tax to 25 cents per dose would be effective for sales after December 31, 2004. No floor stocks refunds would be permitted for vaccines held on December 31, 2004.

VI. SMALL BUSINESS TAX RELIEF PROVISIONS

A. Accelerate 100-Percent Self-Employed Health Insurance Deduction

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.

Employees can exclude from income 100 percent of employer-provided health insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 are as follows: $210 in the case of an individual 40 years old or less; $400 in the case of an individual who is over 40 but not more than 50; $800 in the case of an individual who is more than 50 but not more than 60; $2,120 in the case of an individual who is more than 60 but not more than 70; and $2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

The self-employed health deduction also applies to qualified long-term care insurance premiums treated as medical care for purposes of the itemized deduction for medical expenses.

Description of Proposal

Beginning in 2000, the proposal would increase the deduction for health insurance expenses (and qualified long-term care insurance expenses) of self-employed individuals to 100 percent.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

B. Increase Section 179 Expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $19,000 (for taxable years beginning in 1999) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $19,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

The $19,000 amount is increased to $25,000 for taxable years beginning in 2003 and thereafter. The increase is phased in as follows: for taxable years beginning in 2000, the amount is $20,000; for taxable years beginning in 2001 or 2002, the amount is $24,000; and for taxable years beginning in 2003 and thereafter, the amount is $25,000.

Description of Proposal

The proposal would provide that the maximum dollar amount that may be deducted under section 179 is increased to $30,000 for taxable years beginning in 2000 and thereafter, without the present-law phase-in rule.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Repeal of Temporary Federal Unemployment Surtax

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4-percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4-percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8-percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 2007.

Description of Proposal

The proposal would repeal the temporary FUTA surtax after December 31, 2004.

Effective Date

The provision would be effective for labor performed on or after January 1, 2005.

D. Coordinate Farmer Income Averaging and the Alternative Minimum Tax

Present Law

An individual taxpayer may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. The averaging election is not coordinated with the alternative minimum tax. Thus, some farmers may become subject to the alternative minimum tax solely as a result of the averaging election.

Description of Proposal

The proposal would coordinate farmer income averaging with the alternative minimum tax. Under the proposed coordination, a farmer would owe alternative minimum tax only to the extent he or she would have owed alternative minimum tax had averaging not been elected. This result would be achieved by excluding the impact of the election to average farm income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

VII. ESTATE AND GIFT TAX RELIEF

A. Reduce Estate, Gift, and Generation-Skipping Transfer Taxes

Present Law

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are 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. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between $10 million and the amount necessary to phase out the benefits of the graduated rates.

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax a total of $650,000 in 1999, $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter.

A generation-skipping transfer ("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 a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. The GST tax is imposed at the top estate and gift tax rate (which, under present law is 55 percent) on cumulative generation-skipping transfers in excess of $1 million.

The basis of property acquired or passing from a decedent is its fair market value on the date of the decedent's death (or, if the alternative valuation date is elected, the earlier of six months or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of any income on the appreciation of the property that occurred prior to the decedent's death, and it also has the effect of eliminating any tax benefit from any unrealized loss.

Description of Proposal

Beginning in 2001, the 5-percent surtax, which phases out the graduated rates, and the rates in excess of 50 percent would be repealed. Beginning in 2004, the unified credit would be replaced with a unified exemption. Beginning in 2007, the unified exemption amount would be increased from $1 million to $1.5 million.

Effective Date

The 5-percent surtax and the rates in excess of 50 percent would be repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2000. The unified credit would be replaced with a unified exemption for estates of decedents dying and gifts made after December 31, 2003. The unified exemption amount would be increased to $1.5 million for estates of decedents dying and gifts made after December 31, 2006.

B. Expand Estate Tax Rule for Conservation Easements

Present Law

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

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

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor.

Description of Proposal

The proposal would expand the rule for conservation easements by increasing to 50 miles the distance within which the land must be situated from a metropolitan area, national park, or wilderness area in order to be a qualified conservation easement. The proposal also would clarify that the date for determining easement compliance is the date on which the donation was made.

Effective Date

The proposal to clarify the date for determining easement compliance would be effective for estates of decedents dying after December 31, 1997. The proposal to expand the distance rule would be effective for estates of decedents dying after December 31, 1999.

C. Increase Annual Gift Exclusion

Present Law

An annual exclusion of $10,000 of transfers of present interests in property is provided for each donee. If the non-donor spouse consents to split the gift with the donor spouse, the annual exclusion is $20,000 for each donee. Unlimited transfers between spouses are permitted without imposition of a gift tax. In the case of gifts made after 1998, the $10,000 amount is increased by a cost-of-living adjustment.

Description of Proposal

Beginning in 2001 and through 2003, the annual gift tax exclusion would be increased to $15,000 for each donee. Beginning in 2004 and thereafter, the annual gift tax exclusion would be increased to $20,000 for each donee.

Effective Date

The annual gift tax exclusion would be increased to $15,000, for each donee, for gifts made after December 31, 2000, and before January 1, 2004. The annual gift tax exclusion would then be increased to $20,000, for each donee, for gifts made after December 31, 2003.

D. Simplification of Generation-Skipping Transfer ("GST") Tax

1. Retroactive allocation of the GST tax exemption

<u>Present Law</u>

A 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 a generation 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 (indexed beginning in 1999) 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.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates GST tax exemption to a trust prior to the taxable termination or taxable distribution, GST tax may be avoided.

A transferor will likely not allocate GST tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and GST tax exemption had not been allocated to the trust, then GST tax would be due even if the transferor had unused GST tax exemption.

<u>Description of Proposal</u>

The proposal would allow the retroactive allocation of GST exemption when there is an unnatural order of death. Under the provision, if a lineal descendant of the transferor predeceases the transferor, then the transferor may allocate any unused GST exemption to any previous transfer or transfers to the trust on a chronological basis. The proposal would permit a transferor to retroactively allocate GST exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption would be allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date the property was transferred to a trust.

Effective Date

The proposal would apply to deaths of non-skip persons occurring after the date of enactment.

2. Severing of trusts holding property having an inclusion ratio of greater than zero

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 a generation 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 transferred property exceeds the amount of the GST exemption allocated to that property, then the GST tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55 percent) by the "inclusion ratio" and the value of the taxable property at the time of the taxable event. The "inclusion ratio" is the number one minus the "applicable fraction." The applicable fraction is a fraction calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.

Under Treas. Reg. 26.2654-1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ration of one) 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). Under current Treasury regulations, however, a trustee cannot sever a trust that is subject to the GST tax after the trust has been created.

Description of Proposal

The proposal would allow a trust to be severed in a "qualified severance." A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the proposal, a trustee could elect to sever a trust in a qualified severance at any time.

Effective Date

The proposal would be effective for severances of trusts occurring after the date of enactment.

3. Modification of certain valuation rules

Present Law

Under present law, the inclusion ratio is determined using gift tax values for allocations of GST tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of GST tax exemption made to transfers at death. Treas. Reg. 26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

Description of Proposal

The proposal would provide that, in connection with timely and automatic allocations of GST transfer tax, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of an allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Effective Date

The provision would be effective as though included in the amendments made by section 1431 of the Tax Reform Act of 1986.

4. Relief from late elections

Present Law

A 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 a generation 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.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under present law) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "GST exemption" allocated to a trust. The allocation of GST exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused GST exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual may elect out of the automatic allocation for lifetime direct skips.

Under present law, an election to allocate GST tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust that is not a direct skip, then the value on the date of transfer to trust is used for determining GST tax exemption allocation. However, if the allocation relating to a such transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate GST tax exemption. Current Treasury regulations may permit relief from failure to make an election only if relief is requested, under certain circumstances, within 6 months of the date of the failure.

Description of Proposal

The proposal would authorize and direct the Treasury Secretary to grant extensions of time to make the election to allocate GST tax exemption and to grant exceptions to the time requirement. When such relief is granted, the value on the date of transfer to a trust is used for determining GST tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) would be treated as if not expressly prescribed by statute.

Effective Date

The proposal to provide relief from late elections would apply to requests pending on, or filed after, the date of enactment.[58]

5. Substantial compliance

Present Law

Under present law, there is no statutory rule which provides that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption will suffice to establish that GST tax exemption was allocated to a particular transfer or trust.

Description of Proposal

The proposal would provide that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption would suffice to establish that GST tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates an intent to have an inclusion ratio of zero with respect to a particular transfer or trust, then so much of the transferor's unused GST tax exemption will be allocated to the extent it produces, when possible, a zero inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances would be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

Effective Date

The substantial compliance provisions would take effect on the date of enactment and would apply to allocations made prior to such date for purposes of determining the tax consequences of generation-skipping transfers with respect to which the period of time for filing claims for refund has not expired.[59]

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[58] No inference is intended with respect to the application of a rule of substantial compliance prior to enactment of this provision.

[59] No inference is intended with respect to the application of a rule of substantial compliance prior to enactment of this provision.

VIII. TAX-EXEMPT ORGANIZATION PROVISIONS

A. Provide Tax Exemption for Organizations Created by a State to Provide Property and Casualty Insurance Coverage for Property for Which Such Coverage Is Otherwise Unavailable

Present Law

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term "corporation" includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

<u>Health coverage for high-risk individuals</u>

Section 501(c)(26) 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. The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for 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 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 the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal would provide tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for property located within the State for which the State has determined that coverage in the authorized insurance market is limited or unavailable at reasonable rates, provided certain requirements are met.

Under the proposal, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association; or (4) to make remittances pursuant to State law to be used by the State to provide for the payment of claims on policies written by the association, purchase reinsurance covering losses under such policies, or to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. Under the proposal, it would be required that the State law governing the association permit the association to levy assessments on insurance companies authorized to sell property and casualty insurance in the State, or on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. Under the proposal, it would be required that the plan of operation of the association be subject to approval by the chief executive officer or other official of the State, by the State legislature, or both. In addition, it would be required that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The proposal would provide a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the proposal, to make disbursements to pay claims on insurance contracts issued by the association, and to make disbursements to support governmental programs to prepare for or mitigate the effects of natural catastrophic events. The special rule would provide that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the proposal, from which it receives such remittances. The election would be required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the proposal, and would be effective as of the effective date of that determination.

An organization described in the proposal would be treated as having unrelated business taxable income ("UBIT") in the amount of its taxable income (computed as if the organization were not exempt from tax under the proposal), if at the end of the immediately preceding taxable year, the organization's net equity exceeded 15 percent of the total coverage in force under insurance contracts issued by the organization and outstanding at the end of that preceding year.

Under the proposal, no income or gain would be recognized solely as a result of the change in status to that of an association exempt from tax under the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

B. Modify Section 512(b)(13)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means 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, present law 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).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's UBI and 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.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications, as described above, to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal would provide that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's UBI, applies only to the portion of payments received in a taxable year that exceed the amount of the specified payment which would have been paid if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) would be included in the parent organizations's UBI. In addition, the proposal would impose a 20 percent penalty on the excess amount of any such payment.

The proposal would provide relief for payments under contracts which, on the date of enactment of the proposal, are subject to the binding contract transition rule of the 1997 Act, but for which the transition rule would expire prior to the effective date of the proposal, by extending the transition rule until December 31, 1999.

Effective Date

The proposal providing an exception from the general rule of section 512(b)(13) for interest, rent, annuity, or royalty payments from controlled subsidiaries that do not exceed fair market value generally would apply to payments received or accrued in taxable years beginning after December 31, 1999.

C. Tax-free Withdrawals from IRAs for Charitable Purposes

Present Law

Under present law, individuals may make deductible contributions to a traditional individual retirement arrangement ("IRA"). Amounts in an IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of after-tax contributions). Includible amounts withdrawn before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity, as well as the fair market value of contributions of property. The amount of the deduction otherwise allowable for the 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.

For donations of cash by individuals, total deductible contributions to public charities may not exceed 50 percent of a taxpayer's adjusted gross income ("AGI") for a taxable year. To the extent a taxpayer has not exceeded the 50-percent limitation, contributions of cash to private foundations and certain other nonprofit organizations and contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's AGI. If a taxpayer makes a contribution in one year which exceeds the applicable 50-percent or 30-percent limitation, the excess amount of the contribution may be carried over and deducted during the next five taxable years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 1999 is $126,600 ($63,300 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. The effect of this reduction may be to limit a taxpayer's ability to deduct some of his or her charitable contributions.

Description of Proposal

The proposal would provide an exclusion from gross income for qualified charitable distributions from an IRA: (1) to a charitable organization to which deductible contributions can be made; (2) to a charitable remainder annuity trust or charitable remainder unitrust; (3) to a pooled income fund (as defined in sec. 642(c)(5)); or (4) for the issuance of a charitable gift annuity. The exclusion would apply with respect to distributions described in (2), (3), or (4) only if no person holds an income interest in the trust, fund, or annuity attributable to such distributions other than the IRA owner, his or her spouse, or a charitable organization.

In determining the amount includible in gross income by reason of a payment from a charitable remainder annuity trust or charitable remainder unitrust to which a qualified charitable distribution from an IRA was made, the taxpayer would be required to treat as ordinary income (as described in sec. 664(b)(1)) the portion of the distribution from the IRA to the trust which would have been includible in income but for the proposal. Similarly, in determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the taxpayer would not be permitted to treat the portion of the distribution from the IRA used to purchase the annuity as an investment in the annuity contract.

A qualified charitable distribution would be treated as any distribution from an IRA which is made after age 70-1/2, and which is made directly to the charitable organization or to a charitable remainder annuity trust, charitable remainder unitrust, or charitable gift annuity (as described above).

The amount otherwise allowable as a deduction to the individual for the year as charitable contributions would be reduced by the amount of qualified charitable distributions.

Effective Date

The proposal would be effective with respect to distributions after December 31, 2000.

D. Provide Exclusion for Mileage Reimbursements by Charitable Organizations

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to providing donated services to a qualified charitable organization--such as out-of-pocket transportation expenses necessarily incurred in performing donated services--may constitute a deductible contribution (Treas. Reg. sec. 1.170A-1(g)).[60] However, no charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (sec. 170(j)). Moreover, a taxpayer may not deduct as a charitable contribution out-of-pocket expenditures incurred on behalf of a charity if such expenditures are made for the purposes of influencing legislation (sec. 170(f)(6)).

For purposes of computing the charitable contribution deduction for the use of a passenger automobile (including vans, pickups, and panel trucks) in connection with providing donated services to a qualified charitable organization, the standard mileage rate is 14 cents per mile (sec. 170(i)). Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent the reimbursement exceeds 14 cents per mile.

Description of Proposal

Under the proposal, reimbursement by an entity or organization described in section 170(c) (including public charities and private foundations) for the costs of using an automobile in connection with providing donated services would be excludable from the gross income of the volunteer, provided that (1) reimbursement does not exceed the rate prescribed for business use, and (2) applicable recordkeeping requirements are satisfied. The proposal would not permit a volunteer to exclude a reimbursement from income if the volunteer claims a deduction or credit with respect to his or her automobile transportation expenses incurred in connection with providing donated services.

Effective Date

[60] Treasury Regulation section 1.170A-1(g) allows taxpayers to deduct only their own unreimbursed expenses incurred in performing services for a qualified charitable organization, and not expenses incident to a third party's performance of services. See Davis v. United States, 495 U.S. 472 (1990).

The proposal would be effective for taxable years beginning after December 31, 1999.

E. Charitable Contribution Deduction for Certain Expenses Incurred in Support of Native Alaskan Subsistence Whaling

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution (Treas. Reg. sec. 1.170A-1(g)). Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

Description of Proposal

The proposal would allow individuals to claim a deduction under section 170 not exceeding $7,500 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction would be available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The proposal would allow a deduction for reasonable and necessary expenses paid by the taxpayer during the taxable year for (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions for carrying out such activities, and (3) storage and distribution of the catch from such activities.

For purposes of the proposal, the term "sanctioned whaling activities" means subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo Whaling Commission.

Effective Date

The proposal would be effective for taxable years ending after December 31, 1999.

F. Simplify Lobbying Expenditure Limitations

Present Law

An organizations does not qualify for tax-exempt status as a charitable organization under section 501(c)(3) unless no substantial part of its activities constitutes carrying on propaganda or otherwise attempting to influence legislation (commonly referred to as "lobbying"). For purposes of determining whether legislative activities are a substantial part of a public charity's overall functions, a public charity may elect either the "substantial part" test or the "expenditure" test.

The substantial part test uses a facts and circumstances approach to measure the permissible level of legislative activities. Because there is no statutory or regulatory guidance, it is not clear whether the determination is based on the organization's activities, or its expenditures, or both.[61]

As an alternative to the substantial part test, the expenditure test permits public charities to elect to be governed by specific expenditure limitations on their lobbying activities under section 501(h). The expenditure test establishes two expenditure limits: one restricts the total amount of lobbying expenditures the public charity can make, the other restricts grass roots lobbying expenditures as a subset of total lobbying expenditures. A public charity's total lobbying expenditures for a year are the sum of its expenditures for direct lobbying and its expenditures for grass roots lobbying.

Direct lobbying is defined as an attempt to influence legislation through communication with a member or staff of a legislative body or with any other government official or employee who may participate in the formulation of legislation. The communication will constitute direct lobbying only if such communication "refers to specific legislation" and reflects a view on such legislation (Treas. Reg. sec. 56.4911-2(b)(1)(ii)). Grass roots lobbying is defined as an attempt to influence legislation through a communication with members of the public that seeks to affect their opinions about the legislation (Treas. Reg. sec. 56.4911-2(b)(2)(i)). The communication must refer to specific legislation, reflect a view on the legislation, and encourage the recipient of the communication to take action with respect to the legislation.

Under the expenditure test, a public charity will be denied exemption under section 501(c)(3) because of lobbying activities only if it "normally" either (1) makes total lobbying expenditures in excess of the "lobbying ceiling amount" or (2) makes grass roots expenditures in excess of the "grass roots ceiling amount" (sec. 501(h)(1)). The lobbying ceiling amount is 150 percent of the organization's "lobbying nontaxable amount" and the grass roots ceiling amount is 150 percent of the "grass roots nontaxable amount." The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose

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[61] A few cases provide some guidance on this issue. See <u>Seasongood v. Commissioner</u>, 227 F.2d 907 (6th Cir. 1955); <u>Christian Echoes National Ministry, Inc. v. United States</u>, 470 F.2d 849 (10th Cir. 1972), <u>cert. denied</u>, 414 U.S. 864 (1973); <u>Haswell v. United States</u>, 500 F.2d 1133 (Ct. Cl. 1974)).

expenditures. The grass roots nontaxable amount is 25 percent of the organization's lobbying nontaxable amount for that taxable year. A public charity that has elected the expenditure test and that exceeds either or both of these limitations is subject to a 25 percent tax on the greater of the two excess lobbying expenditures.

Description of Proposal

The proposal would remove the separate percentage limitation on grass roots lobbying expenditures. Consequently, public charities would be subject to an expenditure limitation only on their total lobbying expenditures.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

G. Charitable Giving Proposals

Present Law

Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity made within a taxable year (generally, January 1-December 31 for calendar-year taxpayers), as well as the fair market value of contributions of property. The amount of the deduction otherwise allowable for the 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. Taxpayers who do not itemize their deductions are not permitted to claim charitable contribution deductions.[62]

For donations of cash by individuals, total deductible contributions to public charities, private operating foundations, and certain types of private non-operating foundations may not exceed 50 percent of a taxpayer's "contribution base," which is typically the taxpayer's adjusted gross income ("AGI"), for a taxable year (sec. 170(b)(1)). To the extent a taxpayer has not exceeded the 50-percent limitation, contributions of cash to private foundations and certain other charitable organizations and contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base. If a taxpayer makes a contribution in one year which exceeds the applicable 50-percent or 30-percent limitation, the excess amount of the contribution may be carried over and deducted during the next five taxable years.

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year. (sec. 170(b)(2)).

Description of Proposal

Deadline for contributions to low-income schools extended until return filing date

The proposal would allow taxpayers to claim a charitable contribution deduction for donations to public, private, and parochial low-income elementary and secondary schools made after the end of the taxable year and on or before the date for filing the taxpayer's Federal income tax return. For example, under the proposal, a calendar-year taxpayer could make a contribution to a qualifying school on March 23, 2001, and claim a charitable contribution deduction for that gift

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[62] Beginning in 1982, non-itemizers were allowed a deduction for charitable contributions in addition to the standard deduction. The maximum charitable contribution deduction for non-itemizers was $25 for 1982 and 1983, and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible, without a dollar cap. For 1986, the full amount of contributions was deductible, subject to the limitations generally applicable to charitable deductions under section 170. Beginning in 1987, the charitable contribution deduction for non-itemizers was no longer effective.

on his or her Federal income tax return for the year 2000 filed on April 15, 2001.[63] For purposes of the proposal, a low-income school would be defined as one where more than 50 percent of the students qualify for free or reduced price lunches.

Charitable contribution deduction for non-itemizers

For 2000 and 2001, the proposal would allow taxpayers who do not itemize their deductions to claim an above-the-line deduction for charitable contributions. The deduction would be limited to $50 for individual taxpayers and $100 for taxpayers filing joint returns.

Increase AGI percentage limits for individuals

The proposal would phase up the percentage limitations applicable to charitable contributions by individuals. Beginning in 2002, the proposal would increase the 50-percent and 30-percent limitations by 2 percent per year until the limitations are equal to 60 percent and 40 percent, respectively, in 2006. In 2007, the limitations would be increased to 70 percent and 50 percent, respectively.

Increase AGI percentage limits for corporations

The proposal would phase up the percentage limitation applicable to charitable contributions by corporations. Beginning in 2002, the proposal would increase the 10-percent limitation by 2 percent per year until the limitation is equal to 20 percent in 2006.

Effective Date

The proposal extending the deadline for contributions to certain low-income schools would be effective for taxable years beginning after December 31, 1999. The proposal permitting non-itemizers to claim a charitable contribution deduction would be effective for taxable years 2000 and 2001. The proposals increasing the percentage limitations for individual and corporate taxpayers would be effective for taxable years beginning after December 31, 2001.

[63] The taxpayer would not be permitted to claim a deduction for the same gift on his or her 2001 Federal income tax return filed in 2002.

TITLE IX. INTERNATIONAL TAX RELIEF PROVISIONS

A. Allocate Interest Expense on Worldwide Basis

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign- source gross income, on the other. Generally, it is left to the Treasury to provide detailed rules for the allocation and apportionment of expenses.

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below.) The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns. (See, e.g., Treas. Reg. sec. 1.861-11T(g).)

Definition of affiliated group--consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation. In addition, for each such other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

Generally the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Definition of affiliated group--special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other. For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rule does not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group. Moreover, Congress in 1986 expressly considered and rejected a rule that would have accomplished a result more consistent with worldwide fungibility by taking foreign members' indebtedness into account when allocating the interest expense of the domestic members (H. Rept. 99-841, II-605 (1986)). In practice, the limit in the degree of fungibility recognized by present law can reduce the foreign tax credit limitations that otherwise would apply if the principle of fungibility were extended to foreign and domestic members of a commonly controlled group.

The statutory definition of affiliation for purposes of group-wide allocation of interest expenses expressly provides for two exceptions from the definition of affiliation for consolidation purposes, one of which contracts the affiliated group and the other of which expands it.

Banks, savings institutions and other financial affiliates

Under the first-mentioned exception, the affiliated group for interest allocation purposes generally excludes what are referred to in the regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies, subsidiaries of banks and bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Section 936 corporations

Under the second exception referred to above, the affiliated group for interest allocation purposes includes any corporation that has elected the application of the possession tax credit for the taxable year, if the corporation would be excluded solely for this reason from the affiliated group as defined for consolidation purposes (sec. 864(e)(5)(A)).

Description of Proposal

Worldwide affiliated group election

The proposal would modify the present-law interest expense allocation rules under section 864(e) by providing a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally would be determined by allocating and apportioning all interest expense of the domestic members of the worldwide affiliated group on a worldwide-group basis. The election would provide taxpayers with the option either to apply fungibility principles on a worldwide basis or to continue to apply present law. For purposes of the new elective rules based on worldwide fungibility, the affiliated group (as that term is used under present law for interest expense allocation purposes) would be expanded to include life insurance companies (without regard to whether such companies are covered by an election under section 1504(c)(2)) and foreign corporations that would be included in the affiliated group under section 1504 if they were domestic corporations (i.e., foreign corporations in which members of the affiliated group own stock possessing at least 80 percent of the foreign corporation's vote and value). Thus, subject to certain exceptions described below, the taxable income from sources outside the United States of the domestic members of an electing worldwide affiliated group would be determined by allocating and apportioning interest expense as if all of the interest expense and assets of 80-percent or greater owned domestic and foreign corporations were attributable to a single corporation.

The general rules under present law would apply to the electing worldwide affiliated group as if it were an affiliated group as defined under present law for interest expense allocation purposes. Thus, among other things, the allocation and apportionment of interest expense would continue to be made on the basis of assets (rather than gross income), but would include the assets of the foreign members of the worldwide affiliated group.

Although the interest expense of an 80-percent owned foreign subsidiary would be taken into account for purposes of allocating the interest expense of the domestic members of the group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary would not be deductible on a U.S. return. After calculating the interest expense allocation of the domestic members based on the worldwide affiliated group, the interest expense preliminarily allocable to foreign-source income would be reduced (but not below zero) by the interest expense taken into account in determining the allocation that was incurred by a foreign corporation to the extent that such interest would be allocated to foreign sources if the proposal's principles were applied separately to the foreign members of the group.

Financial institution group election

With respect to affiliated groups that elect to apply the new worldwide fungibility principle, the proposal would provide a one-time election to expand the bank group rules of present law (sec. 864(e)(5)(B)-(D)). At the election of the common parent of an affiliated group that elects to apply the worldwide approach to the interest expense allocation rules, the worldwide approach could be applied separately to a subgroup of the affiliated group consisting of the present-law bank group and all members of the worldwide affiliated group that are predominantly engaged in a banking, insurance, financing, or similar business. For this purpose, a corporation would be predominantly engaged in such a business if at least 80 percent of its gross income is "financial services income" (as described in section 904(d)(2)(C)(ii) and the regulations thereunder). As is true under present law, to qualify for inclusion in a financial institution group, the financial services income of the corporation must be predominantly from business with unrelated persons.

The financial institution group rules, if elected, would apply to all members of the affiliated group that are considered to be predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. The election would be available only for the first year in which an affiliated group includes a corporation that satisfies the expanded definition of a financial institution but would not qualify as such under the present-law bank group rules. Once made, the election would apply to all corporations that qualify as financial institutions under the expanded definition for the taxable year and all subsequent years. Anti-abuse rules would apply under which certain transfers of funds between a member of the financial institution group and another member of the affiliated group that is not a member of the financial institution group would result in treatment of a portion of the interest expense of the financial institution group as interest expense of the non-financial institution group.

Regulatory authority

The Treasury Secretary would be granted authority to prescribe rules to carry out the purposes of the proposal, including rules (1) to address changes in members of an affiliated group (including acquisitions or other business combinations of affiliated groups in which one group has made an election to apply the worldwide approach and the other group applies current law); (2) to prevent assets and interest expense from being taken into account more than once; and (3) to provide for direct allocation of interest expense in circumstances where such allocation would be appropriate to carry out the purposes of the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2002.

B. Look-Through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may 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 limitations 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").[64] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.

The proposal would provide a transition rule under which pre-effective date foreign tax credits associated with a 10/50 company separate limitation category can be carried forward into post-effective date years. Under the proposal, look-through principles similar to those applicable to post-effective date dividends from a 10/50 company would apply to determine the appropriate

[64] A controlled foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote is treated as a 10/50 company with respect to any distribution out of earnings and profits for periods when it was not a controlled foreign corporation.

foreign tax credit limitation category or categories with respect to the foreign tax credit carryforward.

The proposal also would provide a default rule in cases in which taxpayers are unable to obtain the necessary information to apply the look-through rules with respect to dividends from a 10/50 company. In such cases, the proposal would treat the dividend (or a portion thereof) from such 10/50 company as a dividend that would not be subject to the look-through rules.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2002.

C. Subpart F Treatment of Pipeline Transportation Income and Income from Transmission of High Voltage Electricity

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income, which in turn includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)).

Foreign base company services income includes income from services performed (1) for or on behalf of a related party and (2) outside the country of the CFC's incorporation (sec. 954(e)). Treasury regulations provide that the services of the foreign corporation will be treated as performed for or on behalf of the related party if, for example, a party related to the foreign corporation furnishes substantial assistance to the foreign corporation in connection with the provision of services (Treas. Reg. sec. 1.954-4(b)(1)(iv)).

Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the CFC or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a CFC that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would exempt income derived in connection with the performance of services which are directly related to the transmission of high voltage electricity from the definition of foreign base company services income. Thus, the income of a CFC that owns a high voltage transmission line for the purpose of providing electricity generated by a related party to a third party outside the CFC's country of incorporation would not constitute foreign base company services income. No inference would be intended as to the treatment of such income under present law.

The proposal also would provide an additional exception to the definition of foreign base company oil related income. Under the proposal, foreign base company oil related income would not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the proposed exception would apply whether or not the CFC that owns the pipeline also owns any interest in the oil or gas transported. In addition, the proposed exception would apply to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 2002, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

D. Prohibit Disclosure of APAs and APA Background Files

Present Law

Section 6103

Under section 6103, returns and return information are confidential and cannot be disclosed unless authorized by the Internal Revenue Code.

Return information is defined broadly. Return information includes:

- a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;

- whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing; or

- any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under Title 26 for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.[65]

Section 6110 and the Freedom of Information Act

With certain exceptions, section 6110 makes the text of any written determination the IRS issues available for public inspection. A written determination is any ruling, determination letter, technical advice memorandum, or Chief Counsel advice. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. The Code defines "background file documents" as any written material submitted in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

Before making them available for public inspection, section 6110 requires the IRS to delete specific categories of sensitive information from the written determination and background file documents.[66] It also provides judicial and administrative procedures to resolve disputes over the scope of the information the IRS will disclose. In addition, Congress has also wholly exempted

[65] Sec. 6103(b)(2)(A).

[66] Sec. 6110(c) provides for the deletion of identifying information, trade secrets, confidential commercial and financial information and other material.

certain matters from section 6110's public disclosure requirements.[67] Any part of a written determination or background file that is not disclosed under section 6110 constitutes "return information."[68]

The Freedom of Information Act ("FOIA") lists categories of information that an agency must make available for public inspection.[69] It establishes a presumption that records in the possession of agencies and departments of the executive branch of the U.S. Government are accessible to the public. The FOIA, however, also provides nine exemptions from public disclosure. One of those exemptions is for matters specifically exempted from disclosure by a statute other than the FOIA if the exempting statute meets certain requirements.[70] Section 6103 qualifies as an exempting statute under this FOIA provision. Thus, returns and return information that section 6103 deems confidential are exempt from disclosure under the FOIA.

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[67] Sec. 6110(l).

[68] Sec. 6103(b)(2)(B) ("The term 'return information' means . . . any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110").

[69] Unless published promptly and offered for sale, an agency must provide for public inspection and copying: (1) final opinions as well as orders made in the adjudication of cases; (2) statements of policy and interpretations not published in the Federal Register; (3) administrative staff manuals and instructions to staff that affect a member of the public; and (4) agency records which have been or the agency expects to be, the subject of repetitive FOIA requests. 5 U.S.C. sec. 552(a)(2). An agency must also publish in the Federal Register: the organizational structure of the agency and procedures for obtaining information under the FOIA; statements describing the functions of the agency and all formal and informal procedures; rules of procedure, descriptions of forms and statements describing all papers, reports and examinations; rules of general applicability and statements of general policy; and amendments, revisions and repeals of the foregoing. 5 U.S.C. sec. 552(a)(1). All other agency records can be sought by FOIA request; however, some records may be exempt from disclosure.

[70] Exemption 3 of the FOIA provides that an agency is not required to disclose matters that are:

> (3) specifically exempted from disclosure by statute (other than section 552b of this title) provided that such statute (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld; . . .

5 U.S.C. § 552(b)(3).

Section 6110 is the exclusive means for the public to view IRS written determinations.[71] If section 6110 covers the written determination, the public cannot use the FOIA to obtain that determination.

<u>Advance Pricing Agreements</u>

The Advanced Pricing Agreement ("APA") program is an alternative dispute resolution program conducted by the IRS, which resolves international transfer pricing issues prior to the filing of the corporate tax return. Specifically, an APA is an advance agreement establishing an approved transfer pricing methodology entered into among the taxpayer, the IRS, and a foreign tax authority. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. Alternatively, an APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA program focuses on identifying the appropriate transfer pricing methodology; it does not determine a taxpayer's tax liability. Taxpayers voluntarily participate in the program.

To resolve the transfer pricing issues, the taxpayer submits detailed and confidential financial information, business plans and projections to the IRS for consideration. Resolution involves an extensive analysis of the taxpayer's functions and risks. Since its inception in 1991, the APA program has resolved more than 180 APAs, and approximately 195 APA requests are pending.

Currently pending in the U.S. District Court for the District of Columbia are three consolidated lawsuits asserting that APAs are subject to public disclosure under either section 6110 or the FOIA.[72] Prior to this litigation and since the inception of the APA program, the IRS held the position that APAs were confidential return information protected from disclosure by section 6103.[73] On January 11, 1999, the IRS conceded that APAs are "rulings" and therefore are "written determinations" for purposes of section 6110.[74] Although the court has not yet issued a

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[71] Sec. 6110(m).

[72] <u>BNA v. IRS</u>, Nos. 96-376, 96-2820, and 96-1473 (D.D.C.). The Bureau of National Affairs, Inc. (BNA) publishes matters of interest for use by its subscribers. BNA contends that APAs are not return information as they are prospective in application. Thus at the time they are entered into they do not relate to "the determination of the existence, or possible existence, of liability or amount thereof . . ."

[73] The IRS contended that information received or generated as part of the APA process pertains to a taxpayer's liability and therefore was return information as defined in sec. 6103(b)(2)(A). Thus, the information was subject to section 6103's restrictions on the dissemination of returns and return information. Rev. Proc. 91-22, sec. 11, 1991-1 C.B. 526, 534 and Rev. Proc. 96-53, sec. 12, 1996-2 C.B. 375, 386.

[74] IR 1999-05.

ruling in the case, the IRS announced its plan to publicly release both existing and future APAs. The IRS then transmitted existing APAs to the respective taxpayers with proposed deletions. It has received comments from some of the affected taxpayers. Where appropriate, foreign tax authorities have also received copies of the relevant APAs for comment on the proposed deletions. No APAs have yet been released to the public.

Some taxpayers assert that the IRS erred in adopting the position that APAs are subject to section 6110 public disclosure. Several have sought to participate as *amici* in the lawsuit to block the release of APAs. They are concerned that release under section 6110 could expose them to expensive litigation to defend the deletion of the confidential information from their APAs. They are also concerned that the section 6110 procedures are insufficient to protect the confidentiality of their trade secrets and other financial and commercial information.

Description of Proposal

The proposal would provide that APAs and related background information are confidential return information and are not written determinations as that term is defined in section 6110.

The proposal would also statutorily require an annual report by the Treasury Department on APAs. The annual report would contain the following information:

- Information about the structure, composition, and operation of the APA program office;
- A copy of each current model APA;
- Statistics regarding the amount of time to complete new and renewal APAs;
- The number of APA applications filed during such year;
- The number of APAs executed cumulatively to date and for the year;
- The number of APA renewals issued for the year;
- The number of pending APA requests;
- The number of pending APA renewals;
- The number of APAs executed and pending (including renewals and renewal requests) that are unilateral, bilateral and multilateral, respectively;
- The number of APAs revoked or canceled, and the number of withdrawals from the APA program for the year;
- The number of finalized new APAs and renewals by industry;[75] and

General descriptions of:

- the nature of the relationships between the related organizations, trades, or businesses covered by APAs;

[75] This information was previously released in IRS Publication 3218, "IRS Report on Application and Administration of I.R.C. Section 482."

- the related organizations, trades, or businesses whose prices or results are tested to determine compliance with the transfer pricing methodology prescribed in the APA;
- the covered transactions and the functions performed and risks assumed by the related organizations, trades or businesses involved;
- methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies;
- critical assumptions;
- sources of comparables;
- comparable selection criteria and the rationale used in determining such criteria;
- the nature of adjustments to comparables or tested parties;
- the nature of any range agreed to, including information such as whether no range was used and why, whether an inter-quartile range was used, or whether there was a statistical narrowing of the comparables;
- adjustment mechanisms provided to rectify results that fall outside of the agreed upon APA range;
- the various term lengths for APAs, including rollback years, and the number of APAs with each such term length;
- the nature of documentation required; and
- approaches for sharing of currency or other risks.

The first report would cover the period January 1, 1991, through the calendar year including the date of enactment. The IRS user fee otherwise required to be paid for an APA would be increased by $500. The Secretary would have the authority to provide an appropriate reduction in the IRS user fee for small businesses with respect to an APA. While the proposal statutorily requires an annual report, the proposal is not intended to discourage the Treasury Department from issuing other forms of guidance, such as regulations or revenue rulings, consistent with the confidentiality provisions of the Code.

Effective Date

The proposal would be effective on the date of enactment; accordingly, no APAs or related background file documents would be released to the public after the date of enactment. The first annual Treasury Department report would be required to be published no later than March 30, 2000.

E. Exempt Certain Sales of Frequent-Flyer and Similar Reduced-Fare Air Transportation Rights from Aviation Excise Taxes

Present Law

An 7.5-percent excise tax is imposed on the sale by an air transportation provider of the right to frequent-flyer or similar reduced-fare air transportation. Like the aviation excise taxes imposed on the purchase of actual air transportation, this tax is imposed on all amounts paid for the right to air transportation if the right can be used for transportation to, from, or within the United States. In both cases, tax is imposed without regard to whether the purchase occurs within the United States or elsewhere. Further, the tax generally is imposed without regard to whether the rights ultimately are used for travel (to, from, or within United States or between two or more points in foreign countries) or expire without use.

Description of Proposal

The proposal would exempt from the 7.5-percent tax, air transportation rights sold which are credited to accounts of persons having a mailing address outside the United States. Mailing addresses would be those listed on the records of the operator of the frequent-flyer or similar program.

Effective Date

The proposal would apply to air transportation rights sold after December 31, 1999.

X. HOUSING AND REAL ESTATE TAX RELIEF

A. Increase Low-Income Housing Tax Credit Cap

Present Law

In general, a maximum 70-percent present value tax credit, claimed over a 10-year period is allowed for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of total qualified expenditures.

To claim low-income housing credits, project owners must receive an allocation of credit from a State or local housing credit agency. However, no allocation is required for buildings at least 50 percent financed with the proceeds of tax-exempt bonds that received an allocation pursuant to the private activity bond volume limitation of Code section 146. Such projects must, however, satisfy the requirements for allocation under the State's qualified allocation plan and meet other requirements.

A building generally must be placed in service during the calendar year in which it receives an credit allocation. However, a housing credit agency can make a binding commitment, not later than the year in which the building is placed in service, to allocate a specified credit dollar amount to such building beginning in a specified later year. In addition, a project can receive a "carryover allocation" if the taxpayer's basis in the project as of the close of the calendar year the allocation is made is more than 10 percent of the taxpayer's reasonably expected basis in the project, and the building is placed in service not later than the close of the second calendar year following the calendar year in which the allocation is made. For purposes of the 10-percent test, basis means the taxpayer's adjusted basis in land and depreciable real property, whether or not these amounts are includible in eligible basis. Finally, an allocation of credit for increases in qualified basis may occur in years subsequent to the year the project is placed in service.

Authority to allocate credits remains at the State (as opposed to local) government level unless State law provides otherwise.[76] Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of: (1) credits claimed on additions to qualified basis; (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

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[76] For example, constitutional home rule cities in Illinois are guaranteed their proportionate share of the $1.25 amount, based on their population relative to that of the State as a whole.

Each State annually receives low-income housing credit authority equal to $1.25 per State resident for allocation to qualified low-income projects.[77] In addition to this $1.25 per resident amount, each State's "housing credit ceiling" includes the following amounts: (1) the unused State housing credit ceiling (if any) of such State for the preceding calendar year;[78] (2) the amount of the State housing credit ceiling (if any) returned in the calendar year;[79] and (3) the amount of the national pool (if any) allocated to such State by the Treasury Department.

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a State which, with respect to the previous calendar year allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1, of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the fraction that a State's population enjoys relative to the total population of all qualified States for that year.

The present-law stacking rule provides that a State is treated as using its annual allocation of credit authority ($1.25 per State resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the National pool.

Description of Proposal

The proposal would make several changes to the low-income housing credit. First, the $1.25 per capita cap for each State would be increased to $1.25 per capita or $2 million, whichever is greater. Second, the $1.25 per capita element of the credit cap would be increased to $1.75 per capita This increase would be phased-in by increasing the credit cap by 10 cents per capita each year for five years. The credit cap would be: $1.35 in calendar year 2001; $1.45 in calendar 2002; $1.55 in calendar year 2003; $1.65 in calendar year 2004; and $1.75 in calendar

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[77] A State's population, for these purposes, is the most recent estimate of the State's population released by the Bureau of the Census before the beginning of the year to which the limitation applies. Also, for these purposes, the District of Columbia and the U.S. possessions (i.e., Puerto Rico, the Virgin Islands, Guam, the Northern Marianas and American Samoa) are treated as States.

[78] The unused State housing credit ceiling is the amount (if positive) of the previous year's annual credit limitation plus credit returns less the credit actually allocated in that year.

[79] Credit returns are the sum of any amounts allocated to projects within a State which fail to become a qualified low-income housing project within the allowable time period plus any amounts allocated to a project within a State under an allocation which is canceled by mutual consent of the housing credit agency and the allocation recipient.

year 2005. Third, the stacking rule would be modified so that each State would be treated as using its allocation of the unused State housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the State) and then finally any National pool allocations.

Effective Date

The proposal would be effective for calendar years beginning after December 31, 2000.

B. Tax Credit for Renovating Historic Homes

Present Law

Present law provides an income tax credit for certain expenditures incurred in rehabilitating certified historic structures and certain nonresidential buildings placed in service before 1936 (Code sec. 47). The amount of the credit is determined by multiplying the applicable rehabilitation percentage by the basis of the property that is attributable to qualified rehabilitation expenditures. The applicable rehabilitation percentage is 20 percent for certified historic structures and 10 percent for qualified rehabilitated buildings (other than certified historic structures) that were originally placed in service before 1936.

A nonresidential building is eligible for the 10-percent credit only if the building is substantially rehabilitated and a specific portion of the existing structure of the building is retained in place upon completion of the rehabilitation. A residential or nonresidential building is eligible for the 20-percent credit that applies to certified historic structures only if the building is substantially rehabilitated (as determined under the eligibility rules for the 10-percent credit). In addition, the building must be listed in the National Register or the building must be located in a registered historic district and must be certified by the Secretary of the Interior as being of historical significance to the district.

Description of Proposal

The proposal would permit a taxpayer to claim a 20-percent credit for qualified rehabilitation expenditures made with respect to a qualified historic home which the taxpayer subsequently occupies as his or her principal residence for at least five years. The total credit which could be claimed by the taxpayer would be limited to $20,000.

The proposal would apply to (1) structures listed in the National Register; (2) structures located in a registered national, State, or local historic district, and certified by the Secretary of the Interior as being of historic significance to the district, but only if the median income of the historic district is less than twice the State median income; (3) any structure designated as being of historic significance under a State or local statute, if such statute is certified by the Secretary of the Interior as achieving the purpose of preserving and rehabilitating buildings of historic significance.

For this purpose, a building generally would be considered substantially rehabilitated if the qualified rehabilitation expenditures incurred during a 24-month measuring period exceed the greater of (1) the adjusted basis of the building as of the later of the first day of the 24-month period or the beginning of the taxpayer's holding period for the building, or (2) $5,000. In the case of structures in empowerment zones, in enterprise communities, in a census tract in which 70 percent of families have income which is 80 percent or less of the State median family income, and areas of chronic distress as designated by the State and approved by the Secretary of Housing and Urban Development only the $5,000 expenditure requirement would apply. In addition, for all structures, at least 5 percent of the rehabilitation expenditures would have to be allocable to the exterior of the structure.

To qualify for the credit, the rehabilitation must be certified by a State or local government subject to conditions specified by the Secretary of the Interior.

If a taxpayer ceases to maintain the structure as his or her personal residence within five years from the date of the rehabilitation, the credit would be recaptured on a pro rata basis.

Effective Date

The proposal would be effective for expenditures paid or incurred beginning after December 31, 1999.

C. Provisions Relating to REITs

Present Law

Real estate investment trust ("REITs") are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are restricted to investing in passive investments primarily in real estate and securities. Specifically, a REIT is required to receive at least 95 percent of its income from real property rents and from securities. Amounts received as impermissible "tenant services income" are not treated as rents from real property. In general, such amounts are for services rendered to tenants that are not "customarily furnished" in connection with the rental of real property. Special rules permit amounts to be received from certain "foreclosure property," treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness which such property secured.

A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities of any corporate issuer. Under an exception to this rule, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[80]

A REIT is generally required to distribute 95 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICs") that requires distribution of 90 percent of income. Both REITS and RICs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a "deficiency dividend" and thus as made before the end of the prior taxable year, only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.

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[80] 15 U.S.C. 80a-1 and following.

A REIT that has been or has combined with a C corporation will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies ("RICs"). In the case of a REIT, any distribution made in order to comply with this requirement is treated a being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, under a provision entitled "procedures similar to deficiency dividend procedures", any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years," be treated as applying to the RIC for the non-RIC year. The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those ... for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."

Description of Proposal

Taxable REIT subsidiaries

Under the proposal, a REIT generally could not own more than 10 percent of the total value of securities of a single issuer, in addition to the present law limit of the REIT's ownership to no more than 10 percent of the outstanding voting securities of a single issuer.

For purposes of the new 10 percent value test, securities would generally be defined to exclude safe harbor debt owned by a REIT (as defined for purposes of section 1361(c)(5)(B)(i) and (ii)) if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. In the case of a REIT that owns securities of a partnership, safe harbor debt would be excluded from the definition of securities only if the REIT owns at least 20 percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly, even though it may also derive qualified interest income through its safe harbor debt interest.

An exception to the limitations on ownership of securities of a single issuer would apply in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary. Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 25 percent of the total value of a REIT's assets.

A taxable REIT subsidiary would be able to engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary could provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and could manage or operate properties generally, without causing amounts received or accrued directly or indirectly by REIT for such activities to fail to be treated as rents from real property.

However, the subsidiary could not directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it could lease a qualified lodging facility (e.g, a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises); and the rents paid would be treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary could bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally could not provide to any person rights to any brand name under which hotels or healthcare facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT would be subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary could not deduct interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items) , an excise tax of 100% would be imposed on the portion that was excessive. "Safe harbors" would be provided for certain rental payments where the amounts are de minimis, there is specified evidence that charges to unrelated parties are substantially comparable, certain charges for services from the taxable REIT subsidiary are separately stated, or the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Commissioner of Internal Revenue is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries. The Commissioner shall submit a report to the Congress describing the results of such study.

Health Care REITS

The proposal would permit a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period could be granted.

Conformity with regulated investment company rules

The REIT distribution requirements would be modified to conform to the rules for regulated investment companies. Specifically, a REIT would be required to distribute only 90 percent, rather than 95 percent, of its income.

Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5 percent or more of such class of stock shall be counted in determining whether the 35 percent ownership limitations have been exceeded.

Modification of earnings and profits rules for RICs and REITS

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, would be modified to clarify that, when reason for the determination is that the RIC had non-RIC earnings and profits in the initial year, the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The RIC earnings and profits rules would also be modified to provide an ordering rule similar to the REIT rule, treating a distribution to meet the requirements of no non-RIC earnings and profits as coming first from the earliest earnings and profits accumulated in any year for which the RIC did not qualify as a RIC.

The rule regarding ordering of REIT distributions to cure a failure to distribute non-REIT earnings and profits would be included as part of the REIT deficiency dividend procedure, thereby providing that all REIT distributions (including those made after the end of a taxable year under a deficiency dividend procedure) will be deemed to come from accumulated earnings and profits first if made for the purpose of curing such failure.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 2000. The proposal with respect to modification of earnings and profits rules would be effective for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10 percent of the value of securities of a single issuer would not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of a written binding contract in effect on that date and at all times thereafter until the acquisition. Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities would be grandfathered. This transition would cease to apply to securities of a corporation as of the first day after July 12, 1999 on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004 and at a time when the REIT's ownership is grandfathered under these rules, the election would be treated as a reorganization under section 368(a)(1)(A) of the Code.

D. Increase State Volume Limits on Tax-Exempt Private Activity Bonds

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is limited by State-wide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

The current annual volume limits that apply to private activity tax-exempt bonds increase to $75 per resident of each State or $225 million, if greater, beginning in calendar year 2007. The increase is, ratably phased in, beginning with $55 per capita or $165 million, if greater, in calendar year 2003.

Description of Proposal

The proposal would increase the present-law annual State private activity bond volume limits to $75 per resident of each State or $225 million (if greater) beginning in calendar year 2005. The increase would be phased-in as follows, beginning in calendar year 2001:

Calendar Year	Volume Limit
2001	$55 per resident ($165 million if greater)
2002	$60 per resident ($180 million if greater)
2003	$65 per resident ($195 million if greater)
2004	$70 per resident ($210 million if greater)

Effective Date

The volume limit increases would be effective beginning in calendar year 2001 and be fully effective in calendar year 2005 and thereafter.

XI. MISCELLANEOUS PROVISIONS

A. Repeal Certain Excise Taxes on Rail Diesel Fuel and Inland Waterway Barge Fuels

Present Law

Under present law, diesel fuel used in trains is subject to a 4.3-cents-per gallon General Fund excise tax. Similarly, fuels used in barges operating on the designated inland waterways system is subject to a 4.3-cents-per-gallon General Fund excise tax. In both cases, the 4.3-cents-per-gallon excise tax rates are permanent.

Description of Proposal

The 4.3-cents-per-gallon General Fund excise tax rates on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system would be repealed.

Effective Dates

The proposal would be effective on October 1, 2000.

B. Tax Treatment of Alaska Native Settlement Trusts

Present Law

An Alaska Native Settlement Corporation ("ANC") may establish a Settlement Trust ("Trust") under section 39 of the Alaska Native Claims Settlement Act ("ANCSA") [81] and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgement, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code. The Trust and its beneficiaries are taxed according to the rules of Subchapter J of the Code.

Description of Proposal

An Alaska Native Corporation may establish a Trust under section 39 of ANCSA and if the Trust makes an election for its first taxable year ending after December 31, 1999, no amount will be includible in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust . In addition, unless the Trust fails to meet all the requirements of the provision, the Trust will be permitted to accumulate up to 45 percent of its income each year without tax to the trust or the beneficiaries on that income.

The earnings and profits of the ANC would not be reduced by the amount of a contribution to the Trust. However, the ANC earnings and profits would be reduced (up to the amount of the contribution) as distributions are thereafter made by the Trust that would exceed the Trusts's total undistributed net income for all prior years during which an election is in effect plus the Trust's distributable net income for the current year, computed under Subchapter J.

An electing Trust must distribute at least 55 percent of its adjusted taxable income for the year. If the Trust fails to meet this distribution requirement, tax at trust rates is imposed on the amount of the failure.

Every distribution by the Trust to beneficiaries would be taxable as ordinary income to the beneficiaries. Reporting to beneficiaries for the future could be made on form 1099 rather than on form K-1. Distributions to beneficiaries would be subject to withholding to the extent such

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[81] 43 U.S.C. 1601 et. seq.

distributions, on an annualized basis, exceed the sum of the standard deduction and the personal exemption.

Certain additional restrictions apply. If the beneficial interests in the Trust may be sold or exchanged to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native), then all assets of the Trust that have not been distributed at the end of the taxable year of the Trust become subject to an excise tax; thereafter all amounts retained that were subject to that tax are treated as corpus under subchapter J. Also, if the shares of the ANC may be sold or exchanged to a person in such a manner, the Trust may continue in existence without an excise tax only if no new contributions are made to the Trust and the beneficial interests in the Trust cannot be sold or exchanged in such a manner.

Apart from these rules, the Trust and its beneficiaries would be taxed according to the provisions of subchapter J of the Code.

Effective Date

The provision would be effective for taxable years of Settlement Trusts, and contributions to such Trusts, after December 31, 1999.

C. Allow Corporations to Take Certain Minimum Tax Credits Against Minimum Tax

Present Law

Present law imposes an alternative minimum tax ("AMT") on a corporation to the extent its tentative minimum tax exceeds its regular tax liability.

If a corporation is subject to the AMT in one year, it is allowed a credit ("AMT credit") in a future year in the amount of the AMT imposed. The AMT credit is allowed only to the extent that the regular tax exceeds the tentative minimum tax in a subsequent year. The credit carryforward period is unlimited.

Description of Proposal

The proposal would allow a corporation with long-term AMT credits to use the AMT credit to offset a portion of its tentative minimum tax. The portion so allowed would be the least of : (1) the amount of the corporation's long-term minimum tax credit; (2) 50 percent of the corporation's tentative minimum tax; or (3) the amount by which the corporation's tentative minimum tax exceeds its regular tax for the taxable year.

Under the proposal, an AMT credit would be a long-term minimum tax credit if the credit is attributable to the adjusted net minimum tax of the corporation for a taxable year that began after 1986 and ended before the fifth taxable year immediately preceding the taxable year for which the determination is being made.

Effective Date

The proposal would apply to taxable years beginning after December 31, 2003.

D. Allow Net Operating Losses From Oil and Gas Properties To Be Carried Back for Up to Five Years

Present Law

A net operating loss ("NOL") generally is the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[82] A carryback of an NOL results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year. Special NOL carryback rules apply to (1) casualty and theft losses of individual taxpayers, (2) Presidentially declared disasters for taxpayers engaged in a farming business or a small business, (3) real estate investment trusts, (4) specified liability losses, (5) excess interest losses, and (6) farm losses.

Description of Proposal

The proposal would provide a special five-year carryback for certain eligible oil and gas losses. The carryforward period would remain 20 years. An "eligible oil and gas loss" would be defined as the lesser of (1) the amount which would be the taxpayer's NOL for the taxable year if only income and deductions attributable to operating mineral interests in oil and gas wells were taken into account, or (2) the amount of such net operating loss for such taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that would be attributable to an eligible oil and gas loss would be treated as a separate NOL and taken into account after the remaining portion of the NOL for the taxable year.

Effective Date

The proposal would apply to NOLs arising in taxable years beginning after December 31, 1998.

[82] A taxpayer could elect to forgo the carryback of an NOL.

E. Allow Geogological and Geophysical Costs To Be Deducted Currently

Present Law

In general

Under present law, current deductions are not allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (sec. 263(a)). Treasury Department regulations define capital amounts to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use.[83]

The proper income tax treatment of geological and geophysical costs ("G&G costs") associated with oil and gas production has been the subject of a number of court decisions and administrative rulings. G&G costs are incurred by the taxpayer for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of oil or gas properties by taxpayers exploring for the minerals. Courts have ruled that such costs are capital in nature and are not deductible as ordinary and necessary business expenses.[84] Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[85] The term "property" includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proven at the time the costs are incurred.

Revenue Ruling 77-188

In Revenue Ruling 77-188[86] (hereinafter referred to as the "1977 ruling"), the Internal Revenue Service ("IRS") provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after

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[83] Treas. Reg. sec. 1.263(a)-(1)(b).

[84] See, e.g., *Schermerhorn Oil Corporation*, 46 B.T.A. 151 (1942).

[85] By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

[86] 1977-1 C.B. 76.

analyzing certain variables such as the size and topography of the project area to be explored, the existing information available with respect to the project area and nearby areas, and the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques that are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.

- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

The 1977 ruling further provides that if, on the basis of data obtained from a detailed survey that does not relate exclusively to any particular property within a particular area of interest, an oil or gas property is acquired or retained within or adjacent to that area of interest, the entire G&G exploration expenditures, including those incurred prior to the identification of the particular area of interest but allocated thereto, are to be allocated to the property as a capital cost under section 263(a).

If, however, from the data obtained by the exploratory operations no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the G&G costs related to the exploration is deductible as a loss under section 165 for the taxable year in which that particular project area is abandoned as a potential source of mineral production.

Description of Proposal

The proposal would allow geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be deducted currently.

Effective Date

The proposal would be effective for G&G costs incurred or paid in taxable years beginning after December 31, 1999.

F. Allow Certain Oil and Gas "Delay Rental Payments" To Be Deducted Currently

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 2634). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for "delay rental payments" as a condition of their extension. The Treasury Department has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

Description of Proposal

The proposal would allow delay rental payments to be deducted currently.

Effective Date

The proposal would apply to delay rental payments incurred in taxable years beginning after December 31, 1999.

The legislative history accompanying the provision would state that no inference is intended from the proposal as to the proper treatment of pre-effective date delay rental payments.

G. Simplify the Active Trade or Business Requirement for Tax-Free Spin-offs

Present Law

A corporation generally is required to recognize gain on the distribution of property to its shareholders as if such property had been sold for its fair market value. An exception to this rule is where the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. Among the requirements of section 355 is that, immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business. For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) if the corporation is not engaged in an active trade or business, then substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.

In determining whether a corporation is engaged in the active conduct of a trade or business, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business must constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[87] However, if the corporation is not directly engaged in an active trade or business, then the "substantially all" test requires that at least 90 percent of the value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[88]

Description of Proposal

The proposal would simplify the active trade or business requirement by eliminating the "substantially all" test, and instead, applying the active trade or business requirement on an affiliated group basis. In applying the active trade or business test to an affiliated group, each separate affiliated group (immediately after the distribution) must satisfy the requirement. For the distributing corporation, the separate affiliated group would consist of the distributing corporation as the common parent and all corporations connected with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The separate affiliated group for a controlled corporation would be determined in a similar manner (with the controlled corporation as the common parent).

Effective Date

The proposal would be effective for distributions after the date of enactment.

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[87] Rev. Proc. 99-3, sec. 4.01(33), 1999-1 I.R.B. 111

[88] Rev. Proc. 86-41, sec. 4.03(4), 1986-2 C.B. 716; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

H. Increase the Maximum Dollar Amount of Reforestation Expenditures Eligible for Amortization and Credit

Present Law

Amortization of reforestation costs (sec. 194)

A taxpayer may elect to amortize up to $10,000 ($5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Amortization is taken over 84 months (7 years) and is subject to a mandatory half-year convention.[89] In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (an above-the-line deduction) rather than as an itemized deduction. The amount eligible for amortization has not been increased since the election was added to the Code in 1980.[90]

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity. Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.

Qualifying timber property includes any woodlot or other site that is located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products. The regulations require that the site consist of at least one acre that is devoted to such activities.[91] A taxpayer may hold qualifying timber property in fee or by lease. Where the property is held by one person for life with the remainder to another person, the life tenant is considered the owner of the property for this purpose.

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[89] Under the half-year convention, all reforestation expenditures are considered to be incurred on the first day of the first month of the second half of the taxable year. Thus, an amortization deduction equal to 6/84 of the expenditures for the year is allowed in the first and eighth years and an amortization deduction equal to 1/7 (12/84) of such expenditures is allowed in the second through seventh years.

[90] Sec. 301(a) of the Multiemployer Pension Plan Amendments Act of 1980.

[91] Treas. Reg. sec. 1.194-3(a).

Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.[92]

Reforestation tax credit (sec. 48(b))

A tax credit is allowed equal to 10 percent of the reforestation expenditures incurred during the year that are properly elected to be amortized. An amount allowed as a credit is subject to recapture if the qualifying timber property to which the expenditure relates is disposed of within 5 years.

Description of Proposal

The proposal would increase the amount of reforestation expenditures eligible for 7-year amortization and the reforestation credit from $10,000 to $25,000 per taxable year (from $5,000 to $12,500 in the case of a separate return by a married individual).

For taxable years beginning in 2000 through 2003, no limit would apply to the amount eligible for 7-year amortization.

Effective Date

The proposal would be effective for expenditures paid or incurred in taxable years beginning after December 31, 1999.

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[92] Sec. 1245(b)(7); Treas. Reg. sec. 1.194-1(c).

I. Modify Excise Tax on Arrow Components and Accessories

Present Law

An 12.4 percent excise tax is imposed on the sale by a manufacturer or importer of any shaft, point, nock, or vane designed for use as part of an arrow which (1) is over 18 inches long, or (2) is designed for use with a taxable bow (if shorter than 18 inches). An 11-percent tax is imposed on certain bows and on certain accessories for taxable bows and arrows.

Description of Proposal

The proposal would make two modifications to the excise tax on arrows and arrow accessories. First, the proposal would extend the 12.4-percent tax on arrow components to inserts and outserts designed for use with taxable arrows. Inserts and outserts would be defined as articles used to attach a point to an arrow shaft. Second, the bill would reclassify "broadheads," or arrow points designed for hunting fish or large animals, as arrow accessories subject to the 11-percent tax rather than arrow points subject to the 12.4-percent tax (as under present law).

Effective Date

The proposal would apply to sales by manufacturers beginning on the first day of the first calendar quarter that begins more than 30 days after enactment.

J. Increase Joint Committee on Taxation Refund Review Threshold to $2 Million

Present Law

No refund or credit in excess of $1,000,000 of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues.

Description of Proposal

The proposal would increase the threshold above which refunds must be submitted to the Joint Committee on Taxation for review from $1,000,000 to $2,000,000. The staff of the Joint Committee on Taxation would continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues, and the IRS is expected to cooperate fully in this expanded program.

Effective Date

The proposal would be effective on the date of enactment, except that the higher threshold would not apply to a refund or credit with respect to which a report was made before the date of enactment.

XII. EXTENSION OF EXPIRING PROVISIONS

A. Extension of Research Tax Credit

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 does not apply to amounts paid or incurred after June 30, 1999.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[93]

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[93] A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-based percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-based percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

Alternative incremental research credit regime

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 applies to the taxable year in which the election is made 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.

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").[94]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 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.

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[94] Under a special rule, 75 percent of amounts paid or incurred by a taxpayer 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 sec. 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.

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

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for five years--i.e., generally, for the period July 1, 1999 through June 30, 2004.

In addition, the credit rate applicable under the alternative incremental credit would be increased by one percentage point per step, that is, from 1.65 percent to 2.65 percent when a taxpayer's current-year research expenses exceed a base amount of 1 percent but do not exceed a base amount of 1.5 percent; from 2.2 percent to 3.2 percent when a taxpayer's current-year research expenses exceed a base amount of 1.5 percent but do not exceed a base amount of 2 percent; and from 2.75 percent to 3.75 percent when a taxpayer's current-year research expenses exceed a base amount of 2 percent.

Effective Date

Extension of the research credit would be effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June 30, 2004. The increase in the credit rate under the alternative incremental credit would be effective for taxable years beginning after June 30, 1999.

B. Extend Exceptions Under Subpart F for Active Financing Income

Present Law

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income"). These exceptions are applicable only for taxable years beginning in 1999.[95]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if,

[95] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Description of Proposal

The proposal would extend for five years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The proposal would be effective for taxable years of a foreign corporation beginning after December 31, 1999, and before January 1, 2005, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporation end.

C. Extend Suspension of Income Limitation on Percentage Depletion from Marginal Oil and Gas Wells

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100 percent of the net income from that property in any year (sec. 613(a)).

Special percentage depletion rules apply to oil and gas production from "marginal" properties (sec. 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Farenheit). Under one such special rule, the 100-percent-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

Description of Proposal

The proposal would extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2005.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

D. Extend the Work Opportunity Tax Credit

Present Law

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to a percentage of qualified wages. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 hours or more. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200. The credit is only effective for wages paid to, or incurred with respect to, qualified individuals who began work for the employer before July 1, 1999.

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

Description of Proposal

The proposal would extend the WOTC for five years (through June 30, 2004).

Effective Date

Generally, the proposal would be effective for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer on or after July 1, 1999, and before July 1, 2004.

E. Extend the Welfare-To-Work Tax Credit

Present Law

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

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of this credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

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

The welfare to work credit 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 June 30, 1999.

Description of Proposal

The proposal would extend the welfare-to-work credit for five years, so that the credit would be available for eligible individuals who begin work for an employer before July 1, 2004.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before July 1, 2004.

F. Extend and Modify Tax Credit for Electricity Produced by Wind and Closed-Loop Biomass Facilities

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45).

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 28(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 taxable years and carried forward 15 taxable years (sec. 39).

Description of Proposal

The proposal would extend the present-law tax credit for five years, for facilities placed in service before July 1, 2004. The proposal also would modify the tax credit to include electricity produced from poultry litter, also for facilities placed in service before July 1, 2004. The credit for electricity produced from poultry litter would be available to the lessor/operator of a qualified facility that was owned by a governmental entity.

Effective Date

The extension of the tax credit for electricity produced from wind and closed-loop biomass would be effective for facilities placed in service after June 30, 1999. The modification to include electricity produced from poultry litter would be effective for facilities placed in service after December 31, 1999.

G. Extend Exemption From Diesel Dyeing Requirement for Certain Areas in Alaska

Present Law

An excise tax totaling 24.4 cents per gallon is imposed on diesel fuel. The diesel fuel tax is imposed on removal of the fuel from a pipeline or barge terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations.

In general, the diesel fuel tax does not apply to non-transportation uses of the fuel. Off-highway business uses are included within this non-transportation use exemption. This exemption includes use on a farm for farming purposes and as fuel powering off-highway equipment (e.g., oil drilling equipment). Use as heating oil also is exempt. (Most fuel commonly referred to as heating oil is diesel fuel.) The tax also does not apply to fuel used by State and local governments, to exported fuels, and to fuels used in commercial shipping. Fuel used by intercity buses and trains is partially exempt from the diesel fuel tax.

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA.

The State of Alaska generally is exempt from the Clean Air Act dyeing regime for a period established by the U.S. Environmental Protection Agency (urban areas) or permanently (remote areas). Diesel fuel used in Alaska is exempt from the excise tax dyeing requirements for periods when the EPA requirements do not apply.

Description of Proposal

The proposal would make the excise tax exemption for Alaska urban areas permanent (i.e., independent of the EPA rules).

Effective Date

The proposal would be effective on the date of enactment.

H. Expensing of Environmental Remediation Expenditures

Present Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred in taxable year's ending before January 1, 2001.

Description of Proposal

The proposal would extend the expiration date for eligible expenditures to include those paid or incurred in taxable years ending before July 1, 2004.

In addition, the proposal would eliminate the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency.

Effective Date

The proposal to extend the expiration date would be effective upon the date of enactment. The proposal to expand the class of eligible sites would be effective for expenditures paid or incurred after December 31, 2000.

XIII. REVENUE OFFSET PROVISIONS

A. Modify Foreign Tax Credit Carryover Rules

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 foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Proposal

The proposal would reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1999.

B. Information Returns Relating to the Discharge of Indebtedness by Certain Entities

Present Law

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness of $600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the FDIC, the RTC, the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

The penalties for failure to file correct information reports with the IRS and to furnish statements to taxpayers are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Description of Proposal

The proposal would require that information reporting on discharges of indebtedness also be done by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date

The proposal would be effective with respect to discharges of indebtedness after December 31, 1999.

C. Increase Elective Withholding Rate for Nonperiodic Distributions from Deferred Compensation Plans

<u>Present Law</u>

Present law provides that income tax withholding is required on designated distributions from employer compensation plans (whether or not such plans are tax qualified), individual retirement arrangements ("IRAs"), and commercial annuities unless the payee elects not to have withholding apply. A designated distribution does not include any payment (1) that is wages, (2) the portion of which it is reasonable to believe is not includible in gross income,[96] (3) that is subject to withholding of tax on nonresident aliens and foreign corporations (or would be subject to such withholding but for a tax treaty), or (4) that is a dividend paid on certain employer securities (as defined in sec. 404(k)(2)).

Tax is generally withheld on the taxable portion of any periodic payment as if the payment is wages to the payee. A periodic payment is a designated distribution that is an annuity or similar periodic payment.

In the case of a nonperiodic distribution, tax generally is withheld at a flat 10-percent rate unless the payee makes an election not to have withholding apply. A nonperiodic distribution is any distribution that is not a periodic distribution. Under current administrative rules, an individual receiving a nonperiodic distribution can designate an amount to be withheld in addition to the 10-percent otherwise required to be withheld.

Under present law, in the case of a nonperiodic distribution that is an eligible rollover distribution, tax is withheld at a 20-percent rate unless the payee elects to have the distribution rolled directly over to an eligible retirement plan (i.e., an IRA, a qualified plan (sec. 401(a)) that is a defined contribution plan permitting direct deposits of rollover contributions, or a qualified annuity plan (sec. 403(a)). In general, an eligible rollover distribution includes any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan or qualified annuity plan. An eligible rollover distribution does not include any distribution that is part of a series of substantially equal periodic payments made (1) for the life (or life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over the a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from section 401(k) plans, or the portion of a distribution that is not includible in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

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[96] All IRA distributions are treated as if includible in income for purposes of this rule.

Description of Proposal

Under the proposal, the withholding rate for nonperiodic distributions would be increased from 10 percent to 15 percent. As under present law, unless the distribution was an eligible rollover distribution, the payee could elect not to have withholding apply. The proposal would not modify the 20-percent withholding rate that applies to any distribution that is an eligible rollover distribution.

Effective Date

The proposal would be effective for distributions made after December 31, 1999.

D. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117[97] extended the statutory authorization for these user fees[98] through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees through September 30, 2009. The proposal would also move the statutory authorization for these fees into the Internal Revenue Code.

Effective Date

The proposal would be effective on the date of enactment.

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[97] An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

[98] These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

E. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Present Law

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable heath benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following 4 taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.[99]

Description of Proposal

The present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account would be extended through September 30, 2009. In addition, the present-law minimum benefit requirement would be replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided would be required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level would be the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year would be determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

Effective Date

The proposal generally would be effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before October 1, 2009. The replacement of the present-law minimum benefit requirement with the minimum cost requirement generally would be effective for qualified transfers occurring on or after the date of enactment. The minimum benefit requirement would continue to apply to qualified transfers before the date of enactment. An employer would be permitted to satisfy the minimum benefit requirement with respect to a qualified transfer that occurs on or after the date of enactment during the portion of the cost maintenance period of such transfer that overlaps the benefit maintenance period of a qualified transfer that occurs before the date of enactment. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer would be

[99] Similar provisions regarding transfers of excess defined benefit pension plan assets to retiree health accounts are contained in title I of the Employee Retirement Income Security Act ("ERISA").

permitted to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and would be required to satisfy the minimum cost requirement in 2003 and 2004.

F. Clarify the Tax Treatment of Income and Losses on Derivatives

Present Law

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, or (4) certain copyrights (or similar property) and U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (sec. 475).

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, income or loss. In 1988, the U.S. Supreme Court rejected this interpretation in Arkansas Best v. Commissioner, 485 U.S. 212 (1988), which, relying on the statutory definition of a capital asset described above, held that a loss realized on a sale of stock was capital even though the stock was purchased for a business, rather than an investment, purpose.

In 1993, the Treasury Department issued temporary regulations, which were finalized in 1994, that require ordinary character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. reg. sec. 1.1221-2).

Description of Proposal

The proposal would add three categories to the list of assets gain or loss on which is treated as ordinary (sec. 1221). The new categories would be: (1) commodities derivative financial instruments entered into by derivative dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business.

In defining a hedging transaction, the proposal generally would codify the approach taken by the Treasury regulations, but would modify the rules. The "risk reduction" standard of the regulations would be broadened to one of "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). In addition, the Treasury Secretary would be granted authority to treat transactions that manage other risks as hedging transactions. As under the Treasury regulations, the transaction would have to be identified as a hedge of specified property. Authority would be provided for Treasury regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary also would be given authority to apply these rules to related parties.

Effective Date

The proposal would be effective for any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after the date of enactment.

G. Loophole Closers

1. Limit use of non-accrual experience method of accounting to amounts to be received for the performance of qualified personal services

Present Law

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

A cash method taxpayer is not required to include an amount in income until it is received. A taxpayer may not use the cash method if purchase, production, or sale of merchandise is a material income producing factor. Such taxpayers are generally required to keep inventories and use the accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations, which are corporations (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million.

Description of Proposal

The proposal would limit the use of the non-accrual experience method to amounts that are to be received for the performance of qualified personal services. Amounts to be received for the performance of all other services would be subject to the general rule regarding inclusion in income. Qualified personal services are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of the non-accrual experience method would be conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment would be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.[100]

2. Impose limitation on prefunding of certain employee benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

The present-law deduction limits for contributions to welfare benefit funds do not apply in the case of certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers.

If any portion of a welfare benefit fund reverts to the benefit of an employer that maintains the fund, an excise tax equal to 100 percent of the reversion is imposed on the employer.

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical benefits, disability benefits and group-term life insurance benefits which do not provide for any cash surrender value or other money that can be paid, assigned, borrowed or pledged for collateral for a loan. The exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay and life insurance (other than group-term life) benefits. Thus, the generally applicable deduction limits (secs. 419 and 419A) would apply to plans providing these benefits.

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[100] 1998-51 I.R.B. 16.

In addition, if any portion of a welfare benefit fund attributable to contributions that are deductible pursuant to the 10-or-more employer exception (and earnings thereon) is used for a purpose other than that for which the contributions were made (including cash payments to employees upon termination of the fund), such portion would be treated as reverting to the benefit of the employers maintaining the fund and would be subject to the imposition of the 100-percent excise tax.

No inference would be intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The proposal would be effective with respect to contributions paid or accrued on or after June 9, 1999, in taxable years ending after such date.

3. Modify installment method and prohibit its use by accrual method taxpayers

Present Law

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B)) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[101] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

Description of Proposal

[101] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

Prohibit use of installment method for accrual method dispositions

The proposal generally would prohibit the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The proposal would not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The proposal also would not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(l).

The proposal does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for next ten years. The proposal would not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modify pledge rule

The proposal would also modify the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the proposal, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The proposed modification of the pledge rule would only apply to installment sales where the pledge rule of present law applies. Accordingly, the proposal would not apply to installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), to sales of property used or produced in the trade or business of farming, or to dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The proposal would be effective for installment sales entered into on or after the date of enactment.

4. Limit conversion of character of income from constructive ownership transactions

Present Law

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on long-term capital gain generally is 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.[102]

A pass-thru entity (such as a partnership) generally is not subject to Federal income tax. Rather, each owner includes its share of a pass-thru entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (as to the character and timing of any gain).

Description of Proposal

The proposal would limit the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts ("constructive ownership transaction") with respect to certain financial assets. The amount of long-term capital gain would be limited to the amount of such gain the taxpayer would have had if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount would be treated as ordinary income. An interest charge would be imposed on the amount of gain that is treated as ordinary income.

A taxpayer would be treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to a financial asset, (2) enters into a forward contract to acquire a financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

A "financial asset" would be defined as (1) any equity interest in a pass-thru entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. A "pass-thru entity" would be defined as (1) a regulated investment company, (2) a real estate investment trust, (3) a real estate mortgage investment conduit, (4) an S corporation,

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[102] Section 1234A, as amended by the Taxpayer Relief Act of 1997.

(5) a partnership, (6) a trust, (7) a common trust fund, (8) a passive foreign investment company, (9) a foreign personal holding company, and (10) a foreign investment company.

The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer's income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued at a constant rate[103] during the term of the constructive ownership transaction.

A taxpayer would be treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

Effective Date

This proposal would apply to transactions entered into on or after July 12, 1999.

5. Denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements

Present Law

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.[104]

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[103] The accrual rate would be the applicable Federal rate on the day the constructive ownership transaction closed.

[104] United States v. American Bar Endowment, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (sec. 170(f)(8)).

Description of Proposal

Deduction denial

The proposal[105] would restate present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It would be intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor would be any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It would be intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it would not be intended that the deduction denial rule under the proposal apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor would be considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) would not prevent it from being a personal benefit contract. The proposal would not be intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It would be intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect

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[105] The proposal is similar to H.R. 630, introduced by Mr. Archer for himself and for Mr. Rangel (106th Cong., 1st Sess.).

beneficiary would not be intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

Under the proposal, an individual's family would consist of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity would not be treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. sec. 20.2042-1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) would be treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the proposal) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person would not be treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference would be intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the proposal would be intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The proposal would impose on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the proposal (without regard to when the transfer to the charitable organization was made). The excise tax would not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the proposal, payments would be treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The proposal would require that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the proposal, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it would be intended that a beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this proposal are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The proposal would provide for the promulgation of regulations necessary or appropriate to carry out the purposes of the proposal, including regulations to prevent the avoidance of the purposes of the proposal. For example, it would be intended that regulations prevent avoidance of the purposes of the proposal by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under bona fide charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial proposal would apply to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax proposal would apply to premiums paid after the date of enactment.

The reporting proposal would apply to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the proposal applied to premiums paid after that date).

No inference would be intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The proposal would not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the proposal.

6. Modify estimated tax rules for closely held REITs

Present Law

If a person has a direct interest or a partnership interest in income producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITS that hold property (e.g. mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

Description of Proposal

In the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT would required to accelerate the recognition of year-end dividends attributable to the closely held REIT for purposes of such person's estimated tax payments. A closely held REIT would be defined as one in which at least 50 percent of the vote or value is owed by five or fewer persons. Attribution rules would apply to determine ownership.

Effective Date

The proposal would be effective for estimated tax payments due on or after September 15, 1999.

7. Prohibited allocations of stock in an ESOP of an S corporation

Present Law

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

Description of Proposal

Under the proposal, if there is a prohibited allocation of stock in an ESOP sponsored by an S corporation: (1) an excise tax would be imposed on the employer equal to 50 percent of the amount of the prohibited allocation; and (2) the value of the stock allocated would be includible in the gross income of the employee receiving the prohibited allocation. For purposes of this rule, a prohibited allocation would be an allocation to an individual who, at any time during the year, is either a member of a "deemed 20-percent shareholder group" or is a "deemed 10-percent shareholder" if such shareholders and shareholder groups own, in the aggregate, at least 50 percent of the outstanding stock in the corporation.

An individual would be a member of a "deemed 20-percent shareholder group" if the deemed-owned shares of the individual and his or her family members together equal or exceed 20 percent of the outstanding stock of the corporation. An individual would be a deemed 10-percent shareholder if no family members of the individual own stock in the S corporation and if the individual's deemed-owned shares equal or exceed 10 percent of the outstanding stock of the corporation.

"Deemed-owned shares" would mean: (1) stock allocated to the account of the individual under the ESOP, (2) the individual's share of unallocated stock held by the ESOP, and (3) stock in such corporation represented by any synthetic equity interest. An individual's share of unallocated stock held by an ESOP would be determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether deemed 20-percent shareholder groups and deemed 10-percent shareholders together own 50 percent or more of the outstanding stock of the corporation, deemed-owned shares and shares owned directly by an individual would be taken into account. For purposes of the proposal, outstanding stock of an S corporation would include stock represented by any synthetic equity interest. Family members would include the spouse of an individual, the lineal ascendents and descendants of the individual and his or her spouse, and siblings of the individual and his or her spouse.

The following example illustrates the proposal.

> S Corp has 100 outstanding shares. There are no synthetic equity interests in S Corp. Shareholder A, who is unrelated to any other shareholders of the S corporation, has 25 shares of stock allocated to his account in S Corp's ESOP. Shareholder A owns 20 shares of stock directly. Shareholder B has 10 shares of stock allocated to her account in the S Corp ESOP, and owns 30 shares directly. B's husband and B's son each have 5 shares of stock allocated to their account in the ESOP. A is a "deemed 10 percent shareholder." B, her husband and her son are a "deemed 20-percent shareholder group." A and B's "deemed 20-percent shareholder group" own 50 percent or more of the outstanding stock of S Corp. Thus, if an allocation of stock is made for the year under the ESOP to A, B, B's husband or B's son, such allocation would be a prohibited allocation.

Effective Date

The proposal would be effective with respect to ESOPs of S corporations established after July 14, 1999.

8. Modify anti-abuse rules related to assumption of liabilities

Present Law

Generally, no gain or loss is recognized if property is exchanged for stock of a controlled corporation. The transferor may recognize gain to the extent other property ("boot") is received by the transferor. The assumption of liabilities by the transferee generally is not treated as boot received by the transferor. The assumption of a liability is treated as boot to the transferor, however, "[i]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer...was a purpose to avoid Federal income tax on the exchange, or...if not such purpose, was not a bona fide business purpose." Sec. 357(b). Thus, this exception requires that the principal purpose of having the transferee assume the liability was the avoidance of tax on the exchange.

The transferor's basis in the stock of the transferee received in the exchange is reduced by the amount of any liability assumed, but generally increased in the amount of any gain recognized by the transferor on the exchange. However, a liability that would give rise to a future deduction is not considered a liability for purposes of basis reductions. Similar rules apply in connection with certain tax-free reorganizations.

Description of Proposal

The proposal would delete the limitation that the assumption of liabilities anti-abuse rule only applies to tax avoidance on the exchange itself, and would change "the principal purpose" standard to "a principal purpose." A taxpayer may have "a principal purpose" of tax avoidance even though it is outweighed by other purposes (taken together or separately). In addition, a modification to the basis rule would be made to require a decrease in the transferor's basis in the transferee's stock when a liability, the payment of which would give rise to a deduction, is treated as boot under the anti-abuse rule.

Effective Date

The proposal would be effective for assumptions of liabilities on or after July 15, 1999.

9. Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions

Present Law

Generally, no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and, immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Internal Revenue Code nor the regulations provide the meaning of the requirement that a person “transfer property” in exchange for stock (or a partnership interest). The Internal Revenue Service interprets the requirement consistent with the “sale or other disposition of property” language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101. Thus, a transfer of less than “all substantial rights” to use property will not qualify as a tax-free exchange and stock received will be treated as payments for the use of property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the Service's position and held that the transfer of a nonexclusive license to use a patent (or any transfer of “something of value”) could be a “transfer” of “property” for purposes of the nonrecognition provision. See E.I. DuPont de Nemours & Co. v. U.S., 471 F.2d 1211 (Ct. Cl. 1973).

Description of Proposal

The proposal would treat a transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor in the property as a transfer of property for purposes of the nonrecognition provisions regarding transfers of property to controlled corporations and partnerships. Consistent reporting by the transferor and transferee would be required. Furthermore, in the case of a transfer of less than all of the substantial rights, the transferor would be required to allocate the basis of the intangible between the retained rights and the transferred rights based upon respective fair market values.

The proposal would not apply to transactions that are properly structured as licenses of intangibles. No inference is intended as to the treatment of these or similar transactions prior to the effective date.

Effective Date

The proposal would be effective for transfers on or after the date of enactment.

10. Modify treatment of closely-held REITs

Present Law

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 pass-through treatment for income that is distributed to shareholders. If an electing 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 tax at the REIT level.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's: (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income.

Under the organizational structure test, 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. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination. No similar rule applies to corporate ownership of a REIT. Certain transactions have been structured to attempt to achieve special tax benefits for an entity that controls a REIT.

Description of Proposal

The proposal would impose as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no one person (e.g., no one corporation) can own stock of a REIT possessing 50 percent or more of the combined voting power of all classes of voting stock or 50 percent or more of the total value of shares of all classes of stock of the REIT. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT qualification under present law would apply (secs. 856(d)(5) and 856(h)(3)). The proposal would not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception would apply for a limited period to certain "incubator REITs". An incubator REIT would be a corporation that elects to be treated as an incubator REIT and that meets all the following other requirements. (1) it has only voting common stock outstanding, (2) not more than 50 percent of the corporation's real estate assets consist of mortgages, (3) from not later than the beginning of the last half of the second taxable year, at least 10 percent of the corporation's capital is provided by lenders or equity investors who are unrelated to the corporation's largest shareholder, (4), the corporation must annually increase the value of real estate assets by at least 10 percent, (5) the directors of the corporation must adopt a resolution setting forth an intent to engage in a going public transaction, and (6) no predecessor entity (including any entity from which the electing incubator REIT acquired assets in a transaction in which gain or loss was not recognized in whole or in part) had elected incubator REIT status.

The new ownership requirement would not apply to an electing incubator REIT until the end of the REIT's third taxable year; and could be extended for an additional two taxable years if the REIT so elects. However, a REIT cannot elect the additional two year extension unless the REIT agrees that if it does not engage in a going public transaction by the end of the extended eligibility period, it shall pay Federal income taxes for the two years of the extended period as if it had not made an incubator REIT election and had ceased to qualify as a REIT for those two taxable years. In such case, the corporation shall file appropriate amended returns within 3 months of the close of the extended eligibility period. Interest would be payable, but no substantial underpayment penalties would apply except in cases where there is a finding that incubator REIT status was elected for a principal purpose other than as part of a reasonable plan to engage in a going public transaction. Notification of shareholders and any other person whose tax position would reasonably be expected to be affected is also required.

If an electing incubator REIT does not elect to extend its initial 2-year extended eligibility period and has not engaged in a going public transaction by the end of such period, it must satisfy the new control requirements as of the beginning of its fourth taxable year (i.e., immediately after the close of the last taxable year of the two-year initial extension period) or it will be required to notify its shareholders and other persons that may be affected by its tax status, and pay Federal income tax as a corporation that has ceased to qualify as a REIT at that time.

If the Secretary of the Treasury determines that an incubator REIT election was filed for a principal purpose other than as part of a reasonable plan to undertake a going public transaction, an excise tax of $20,000 would be imposed on each of the corporation's directors for each taxable year for which the election was in effect.

A going public transaction would be defined as either (1) a public offering of shares of stock of the incubator REIT, (2) a transaction, or series of transactions, that result in the incubator REIT stock being regularly traded on an established securities market (as defined in section 897) and being held by shareholders unrelated to persons who held such stock before it began to be so regularly traded, or (3) any transaction resulting in ownership of the REIT by 200 or more persons (excluding the largest single shareholder) who in the aggregate own least 50 percent of the stock of the REIT. Attribution rules apply in determining ownership of stock.

Effective Date

The proposal would be effective for entities electing REIT status for taxable years ending after July 14, 1999. Any entity that elects REIT status for a taxable year including July 14, 1999, and which is both a controlled entity and has significant business assets or activities on such date, will not be subject to the proposal.

Under this rule, a controlled entity with significant business assets or activities on July 14, 1999, can be grandfathered even if it makes its first REIT election after that date with its return for the taxable year including that date. In such a case, the significant assets in place on July 14, 1999, must be real estate assets that would be qualified real estate assets for purposes of the REIT asset rules. The assets and activities in place on that date must also be of a type that would produce qualified real estate-related income for a REIT.

11. Distributions by a partnership to a corporate partner of stock in another corporation

Present Law

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80-percent-owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

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).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under section 332.[106]

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[106] In a similar situation involving the purchase of stock of a subsidiary corporation as replacement property following an involuntary conversion, the Code generally requires the basis of the assets held by the subsidiary to be reduced to the extent that the basis of the stock in the replacement corporation itself is reduced (sec. 1033).

Description of Proposal

In general

The proposal would provide for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction would apply if, after the distribution, the corporate partner controls the distributed corporation.

Amount of the basis reduction

Under the proposal, the amount of the reduction in basis of property of the distributed corporation generally would equal the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The proposal would, however, limit the amount of the basis reduction in two respects. First, the amount of the basis reduction could not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Thus, for example, if the distributed corporation has cash of $300 and other property with a basis of $600 and the corporate partner's basis in the stock of the distributed corporation is $400, then the amount of the basis reduction could not exceed $500 (i.e., ($300+$600) - $400 = $500).

Second, the amount of the basis reduction could not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the proposal, even though the total amount of the basis reduction would otherwise be greater.

The proposal would provide that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction does exceed the basis of the property (other than money) of the distributed corporation. For example, if the amount of the basis reduction were $400, and the distributed corporation has money of $200 and other property with an adjusted basis of $300, then the corporate partner would recognize a $100 capital gain under the proposal. The corporate partner's basis in the stock of the distributed corporation would also be increased by $100 in this example, under the proposal.

Partnership distributions resulting in control

The basis reduction generally would apply with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control would mean ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement). The proposal would apply to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The proposal would not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control. Under the proposal, a corporation would be treated as receiving a distribution of stock from a partnership, if the corporation acquires stock other than in a distribution from a partnership and the basis of the stock is determined in whole or in part by reference to the partnership rules limiting the basis of the stock to a partner's basis in his partnership interest (secs. 732(a)(2) or 732(b)).

Effective Date

The proposal would be effective for distributions made after July 14, 1999.

XIV. TAX TECHNICAL CORRECTIONS

The following technical corrections provisions would be adopted. Except as otherwise provided, the technical corrections generally would be effective as if included in the originally enacted related legislation.

Amendments related to Tax and Trade Relief Extension Act of 1998

Exempt organizations.–The proposed change would clarify that nonexempt charitable trusts and nonexempt private foundations are subject to the public disclosure requirements of section 6104(d).

Capital gains.–The proposed change would provide that if (1) a charitable remainder trust sold section 1250 property after July 28, 1997, and before January 1, 1998, (2) the property was held more than one year but not more than 18 months, and (3) the capital gain is distributed after December 31, 1997, then any capital gain attributable to depreciation will be taxed at 25 percent (rather than 28 percent). Treasury has published a notice (Notice 99-17, 1999-14 I.R.B., April 5, 1999) providing that the gain is taxed at 25 percent.

Vaccine Trust Fund.–In the 1998 Act, the tax on vaccines against rotavirus gastroenteritis and the technical correction regarding the Vaccine Injury Compensation Trust Fund expenditure purposes were inadvertently included twice, once in the spending title and once in the revenue title. In addition, in the spending title, the effective date of the substantive change to the expenditure program is drafted erroneously, such that claims to the Trust Fund for this new expenditure purpose cannot be paid. The proposed changes would clarify that intended vaccine tax and Trust Fund provisions regarding program spending authority are those included in the revenue title, and would modify the revenue title provisions as necessary to allow spending for the new purpose created elsewhere in the Act.

Amendments related to Internal Revenue Service Restructuring and Reform Act of 1998

IRS restructuring.--When the Office of the Chief Inspector was replaced by the Treasury Inspector General for Tax Administration (TIGTA) under the IRS Restructuring and Reform Act of 1998, Inspection's responsibilities were assigned to the TIGTA. TIGTA personnel are Treasury, rather than IRS, personnel. TIGTA personnel still need to make investigative disclosures to carry out the duties they took over from Inspection and their additional tax administration responsibilities. However, section 6103(k)(6) refers only to "internal revenue" personnel. The proposed change would clarify that section 6103(k)(6) permits TIGTA personnel to make investigative disclosures.

Compliance.--Section 3509 of the IRS Restructuring and Reform Act of 1998 expanded the disclosure rules of section 6110 to also cover Chief Counsel advice (sec. 6110(i)). This is a conforming change related to ongoing investigations. The proposed change would add to section 6110(g)(5)(A) after the words technical advice memorandum, "or Chief Counsel advice."

Amendments related to Taxpayer Relief Act of 1997

Roth IRAs.--Code section 3405 provides for withholding with respect to designated distributions from certain tax-favored arrangements, including IRAs. In general, section 3405(e)(1)(B)(ii) excludes from the definition of a designated distribution the portion of any distribution which it is reasonable to believe is excludable from gross income. However, all distributions from IRAs are treated as includible in income. The exception was consistent with prior law when all IRA distributions were taxable, but does not account for the tax-free nature of certain Roth IRA distributions. The proposed change would extend the exception to Roth IRAs.

Transportation benefits.--Under present law, salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits. The proposed change would treat salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

Tax Court jurisdiction.--The Tax Court recently held that its jurisdiction pursuant to section 7436 extends only to employment status, not to the amount of employment tax in dispute (Henry Randolph Consulting v. Comm'r, 112 T.C. #1, Jan. 6, 1999). The proposed change would provide that the Tax Court also has jurisdiction over the amount.

Amendments to other Acts

Worthless securities.--Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. The test for affiliation in section 165(g)(3)(A) is the 80-percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the test had been the same until then. The proposed change would conform the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

Work opportunity tax credit.–Section 51(d)(2) refers to eligibility for the work opportunity tax credit with respect to certain welfare recipients without taking into account the enactment of the temporary assistance for needy families ("TANF") program. The proposed changes would conform references in the work opportunity tax credit to the operation of TANF, effective as if included in the amendments made by section 1201 of the Small Business Job Protection Act of 1996.

IRAs for nonworking spouses.--Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contributions is generally limited by the individual's earned income. However, under present law, it is possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple's combined earned income. The following example illustrates present law.

Example: Suppose H and W retire in the middle of January, 1999. In that year, H earns $1,000 and W earns $500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is $60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is $1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is $200, and H contributes that amount to an IRA. Under 408(o)(2)(B), H can make nondeductible contributions of $800 ($1,000 - $200).

W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is $1,300 (the sum of H and W's earned income ($1,500), less H's deductible IRA contribution ($200)). Under the income phase-out, W's deductible contribution is limited to $200, and she can make a nondeductible contribution of $1,000 ($1,300 - $200).

The total permitted contributions for H and W are $2,300 ($1,000 for H plus $1,300 for W). The combined contribution should be limited to $1,500, their combined earned income.

The proposed change would provide that the contributions for the spouse with the lesser income cannot exceed the combined earned income of the spouses. The proposed change would be effective as if included with section 1427 of the Small Business Job Protection Act of 1996 (i.e., for taxable years beginning after December 31, 1996).

Insurance.--The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)((2), however, arguably might be read to allow a policyholder to exchange a MEC for a contract that does not fail the 7-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the 7-pay test. The proposed change would clarify section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Insurance.--Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the 7-pay limit under the new contract is first be computed without reference to the premium paid using the cash surrender value of the old contract, and then would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract. For example, if the old contract had a cash surrender value of $14,000 and the 7-pay premium on the new contract would equal $10,000 per year but for the fact that there was an exchange, the 7-pay premium on the new contract would equal $8,000 ($10,000 - $14,000/7). However, section 7702a(c)(3)(A) arguably might be read to suggest that if the cash surrender value on the new contract was $0 in the first two years (due to surrender charges), then the 7-pay premium might be $10,000 in this example, unintentionally permitting policyholders to engage in a series of “material changes” to circumvent the premium limitations in section 7702A. The proposed change would clarify section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Definition of lump-sum distribution.--Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed 5-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to NUA in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: “A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution.” The proposed change would add this language back into the definition of lump-sum distribution, effective as if included with section 1401 of the Small Business Job Protection Act of 1996. The sentence is relevant to section 401(k)(10)(B), which permits certain distributions if made as a “lump-sum distribution.”

Losses from section 1256 contracts.--Section 6411 allows tentative refunds for NOL carrybacks, business credit carrybacks and, for corporations only, capital loss carrybacks. Individuals normally cannot carry back a capital loss. However, section 1212(c) does allow a carryback of section 1256 losses, if elected by the taxpayer. The proposed change would amend section 6411(a) by including a reference to section 1212(c), effective as if included with section 504 of the Economic Recovery Tax Act of 1981.

Clerical changes

Individual.--Section 67(f), as enacted in 1988, has a cross reference to “the last sentence of section 162(a).” Additional “last sentences” were later added at the end of section 162(a) in 1992 and 1997. The proposed change would correct the reference in section 67(f).

Excess contributions.--The proposed change would modify the heading for section 408(d)(5) to “Distributions of excess contributions after due date for taxable year and certain excess rollover contributions.”

Qualified State tuition programs.--Under section 529(e)(3)(B) (enacted in the Small Business Job Protection Act of 1996), qualified higher education expenses include room and board expenses of a designated beneficiary who is enrolled at least half-time in a degree program, regardless of whether the qualified state tuition program is a prepaid (i.e., guaranteed) program or a savings program. Therefore, the proposed change would delete the words “under guaranteed plans” from the heading of section 529(e)(3)(B).

S corporations.--Sections 678(e) and 6103(e)(1)(D)(v) refer to “an electing small business corporation under subchapter S of chapter 1.” The reference was inadvertently not changed to “S corporation” when the Subchapter S Revision Act was enacted in 1982, and the proposed change would correct the reference.

Foreign–Military FSCs.--The Tax Reform Act of 1976 added section 995(b)(3)(B), limiting DISC benefits relating to “military property,” which is defined by reference to a list under the “Military Security Act of 1954.” That Act properly was titled the “Mutual Security Act of 1954,” and it had been repealed and superseded by the “International Security Assistance and Arms Export Control Act of 1976" (signed into law June 30, 1976). Section 923 (relating to FSCs) also refers to the definition in section 995(b)(3)(B). Treasury regulations correctly reference the International Security Assistance and Arms Export Control Act of 1976. The proposed change would name the correct Act in the statute.

Private foundation excise taxes.--Section 4946 provides a definition of “government official” for purposes of determining acts of self-dealing under section 4941. In section 4946(c)(3)(B), the definition refers to “compensation at the lowest rate prescribed for GS-16 . . .”. The proposed change would change this language so that it refers to compensation at the lowest rate prescribed for Senior Executive Service (SES) positions.

ERRATA for JCX-46-99
Joint Committee on Taxation
July 20, 1999

1. On page 5, line 2, "one" should be "once."

2. On page 11, the last sentence in the carryover paragraph at the top of the page should read as follows: "Second, the maximum amount of eligible employment-related expenses ($2,400/$4,800) would be indexed for inflation beginning in 2001."

3. On page 20, in the first sentence in the Description of Proposal, "2005" should read "2003."

4. On page 27, the sentence under Effective Date should read as follows: "The proposal would be effective for years beginning after December 31, 2000."

5. On page 37, the following should be added at the end of the first sentence of the second full paragraph: "(maintained by a State or local government)."

6. On page 116, in the Effective Date, strike the words "in taxable years beginning."