106th Congress *1st Session*	SENATE	Report 106-120

TAXPAYER REFUND ACT OF 1999

R E P O R T

of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

to accompany

S. 1429

together with

MINORITY VIEWS

A Bill to Provide for Reconciliation Pursuant to Section 104
of the Concurrent Resolution on the Budget for Fiscal Year 2000

July __, 1999.--Ordered to be printed

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July 23 (legislative day, ____), 1999 - - Ordered to be printed

Mr. Roth, from the Committee on Finance
submitted the following

R E P O R T

together with

MINORITY VIEWS

To accompany S. 1429

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance reported an original bill (S. 1429) to amend the Internal Revenue Code of 1986 to provide for reconciliation pursuant to section 104 of the concurrent resolution on the budget for fiscal year 2000, having considered the same, reports favorably thereon and recommends that the bill do pass.

I. LEGISLATIVE BACKGROUND

Committee markup

The Senate Committee on Finance marked up an original bill (the "Taxpayer Refund Act of 1999") on July 20-21, 1999, and ordered the bill favorably reported by a roll call vote of 13 yeas and 6 nays (13 yeas and 7 nays including a proxy nay) on July 21, 1999. The Committee on Finance (the "Committee") action on the bill was in response to the reconciliation instructions contained in sections 105 and 211 of the Concurrent Resolution on the Budget for Fiscal Year 2000 (H. Con. Res. 68) for a net tax reduction of up to $792 billion for fiscal years 2000-2009.

Committee hearings

The following tax-related Committee hearings were held during the 106th Congress:

- President's fiscal year 2000 budget and tax proposals (February 2, 1999);
- Increasing savings for retirement (February 24, 1999);
- Education tax proposals (March 3, 1999);
- International tax issues relating to globalization (March 11, 1999);
- Personal retirement accounts (March 16, 1999);
- Complexity of the individual income tax (April 15, 1999); and
- Pension reform proposals (June 30, 1999).

TITLE I. BROAD-BASED TAX RELIEF

A. Reduction in the 15-percent Regular Individual Income Tax Rate; Increase in Maximum Taxable Income for 15-Percent Rate Bracket (secs. 101-102 of the bill and sec. 1 of the Code)

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

If taxable income is:	Then income tax equals:
$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

Reasons for Change

Under the budget resolution, the Committee is charged with making recommendations with respect to tax reductions. The Committee believes that it is important to meet these budget reconciliation instructions in part by providing broad-based tax relief that will benefit all Americans who are currently paying Federal income tax. While there are many ways to effectuate broad-based tax relief, the Committee adopts an approach that lowers the 15-percent marginal income tax rate to 14 percent and widens the size of the 14 percent bracket because it delivers across-the-board relief to all taxpayers regardless of income or filing status. Further, the provision will move approximately 4 million middle income Americans out of the 28-percent marginal rate bracket and into the new 14-percent bracket.

Explanation of Provision

The bill reduces the lowest individual regular income tax rate from 15 percent to 14 percent. This rate reduction does not apply to the capital gains tax rates.

The bill also phases in an increase in the size of the 14-percent rate bracket. Specifically, the bill increases the size of the otherwise applicable 14-percent rate bracket by $2,000 ($4,000 for a married couple filing a joint return) in 2005 and 2006, and by $2,500 ($5,000 for a married couple filing a joint return) in 2007 and thereafter. The $2,500/$5,000 amounts in 2007 and thereafter are the total increase and are not in addition to the $2,000/$4,000 amounts in 2005 and 2006. These amounts are indexed for inflation beginning in 2008.

Effective Date

The provision reducing the tax rate from 15 percent to 14 percent is effective for taxable years beginning after December 31, 2000. The provision increasing the size of the rate bracket is effective for taxable years beginning after December 31, 2004.

TITLE II. FAMILY TAX RELIEF PROVISIONS

A. Election to Calculate Combined Tax as Individuals for a Married Couple Filing a Joint Return (sec. 201 of the bill and sec. 6013A)

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.[1] 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.

Reasons for Change

The Committee believes that the Code should not penalize marriage and two individuals should not see their total tax liability increase simply because they get married. The Committee understands that there are a variety of Code provisions that create marriage penalties, and that there are also a number of different ways to reduce or eliminate such penalties. For example, one way to address the marriage penalty would be to modify some or all of the specific provisions of the Code that give rise to a marriage penalty, such as assorted income-phaseout ranges. However, the Committee believes that a comprehensive approach is preferable. It is both fairer and more

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[1] 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.

beneficial to all taxpayers, thus the provision allows married taxpayers to elect to calculate their tax liability as if they were single. This approach is already in use in some states.

While the Committee understands that this approach may make completion of the tax return more complicated for some taxpayers, it has concluded that any increased complexity is outweighed by the added fairness and tax relief provided by the provision. The provision identifies and eliminates the marriage penalty resulting from the income tax rate structure for an electing taxpayer. The Joint Committee on Taxation estimates that, in 2005, approximately 19 million joint returns will experience a reduction in the marriage penalty as a result of this provision.

Explanation of Provision

Under the bill, married taxpayers 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 is calculated by applying the tax rates for single individuals to the separate taxable incomes. Under the bill, both spouses must elect to either use a standard deduction or to itemize their deductions. Thus, one spouse is not permitted to itemize deductions while the other spouse claims 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 is the standard deduction for single individuals. Under the bill, once tax liability is calculated on a separate basis, all tax credits and payments of tax are applied as if the couple is filing a joint return.

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

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

Each spouse is entitled to claim one personal exemption. Exemptions for dependents are allocated based on each spouse’s relative income.

All credits are determined as if the spouses had filed a joint return. The credit amounts are then applied against the combined tax liability of the couple as calculated under this provision.

For purposes of determining the alternative minimum tax imposed by section 55, the tentative minimum tax shall be the tax which would be computed as if the spouses had filed a joint return, and the regular tax shall be the tax liability computed under section 6013A.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

B. Marriage Penalty Relief Relating to the Earned Income Credit (sec. 202 of the bill and sec. 32 of the Code)

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

Reasons for Change

The Committee believes that the present-law EIC unfairly penalizes some individuals by causing them to receive less EIC when they marry than if they had not married. The Committee believes that this unfairness in the tax Code should be reduced.

Explanation of Provision

The bill increases 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 provision, the end-point of the phase-out ranges is also 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 provision also expands the universe of taxpayers eligible for the EIC. Specifically, the $2,000 increase in the end of the phase-out range makes taxpayers with earnings up to $2,000 beyond the present-law phase-out range newly eligible for the credit. Beginning in 2006, the $2,000 amount is indexed for inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

C. Expand the Exclusion from Income for Certain Foster Care Payments (sec. 203 of the bill and sec. 131 of the Code)

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.[2] 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.

Reasons for Change

The Committee recognizes that some States want to use both taxable and tax-exempt organizations to improve the administration of their foster care programs (e.g., out-sourcing of the placement function of their foster care program). This provision is intended to give the States more flexibility in meeting the goals of foster care without expanding the application of the exclusion to payments which are not made under the State's foster care program.

Explanation of Provision

The bill makes two principal modifications to the exclusion for qualified foster care payments. First, the bill expands the list of persons eligible to make qualified foster care payments. Therefore, the exclusion applies 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 bill expands the list of persons eligible to place foster care individuals. Specifically, the bill allows placements by either: (1) a State or a political subdivision of a State; or (2) a qualified foster care placement agency. For these purposes, a qualified foster care placement agency is 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

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[2] 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.

thereof, for the foster care program of such State or political subdivision to make payments to providers of foster care.

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

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

D. Increase and Expand the Dependent Care Credit (sec. 204 of the bill and sec. 21 of the Code)

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.

Reasons for Change

The Committee recognizes that the size of the present-law dependent care credit does not reflect the true cost of dependent care for many families. The Committee believes that increasing the amount of the credit will help millions of working American taxpayers better afford adequate childcare. In addition, the Committee believes that, as the costs of dependent care increase as a result of inflation, the size of the credit should also be increased.

Explanation of Provision

The bill makes two changes to the dependent care tax credit. First, the maximum credit percentage is increased from 30 percent to 50 percent for taxpayers with AGI of $30,000 or less. The 50-percent credit rate is phased-down by one percentage point for each $1,000 of AGI, or fraction thereof, between $30,001 and $59,000. The credit percentage is 20 percent for taxpayers with AGI of $59,001 or greater. Second, the maximum amount of eligible employment-related expenses ($2,400/$4,800) is indexed for inflation beginning in 2001.

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

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

E. Tax Credit for Employer-Provided Child Care Facilities (sec. 205 of the bill and new sec. 45D of the Code)

Present Law

Generally, present law does not provide a tax credit to employers for supporting child care or child care resource and referral services.[3] 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.

Reasons for Change

The Committee believes that providing an incentive to employers to provide child care services for their employees will increase the quality and availability of child care services, which is an important issue for working Americans.

Explanation of Provision

Employer tax credit for supporting employee child care

Under the bill, taxpayers receive a tax credit equal to 25 percent of qualified expenses for employee child care. These expenses include costs incurred: (1) to acquire, construct, rehabilitate or expand property that is to be used as part of the taxpayer's qualified child care facility; (2) for the operation of the 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

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[3] 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.

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

Other rules

The maximum total credit that may be claimed by a taxpayer under this provision can not exceed $150,000 per year. Any amounts for which the taxpayer may otherwise claim a tax deduction are 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 is reduced by the amount of the credits.

Effective Date

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

F. Modify Individual Alternative Minimum Tax
(sec. 206 of the bill and secs. 26 and 56 of the Code)

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.[4]

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.

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[4] 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."

(9) The amount allowable as a deduction for circulation expenditures must be capitalized 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.[5]

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

Other rules

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.[6]

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.

Reasons for Change

The Committee believes that the personal credits and deductions for personal exemptions should not result in a taxpayer having tax liability by reason of the minimum tax.

Explanation of Provision

The bill allows an individual to offset the entire regular tax liability (without regard to the minimum tax) by the personal nonrefundable credits, and repeals the provision reducing the refundable child credit by the AMT.

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

[6] 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 bill also allows the deduction for personal exemptions in computing AMT.

Effective Dates

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

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

TITLE III. RETIREMENT AND INDIVIDUAL SAVINGS TAX RELIEF PROVISIONS

A. Individual Savings Provisions

1. Individual retirement arrangements ("IRAs") (secs. 301-302 and 304 of the bill and secs. 219, 408, and 408A of the Code)

<u>In general</u>

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) differ.

<u>Traditional IRAs</u>

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 neither the individual nor the individual's spouse is an active participant 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 a 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).[7] The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

IRA investments

In general, IRAs may not invest in collectibles. Under one exception to this rule, IRAs may invest in certain gold, silver, and platinum coins and coins issued under the laws of any State.

Reasons for Change

The Committee is concerned about the low national savings rate, and that individuals may not be saving adequately for retirement. Present law provides tax incentives for savings, including the opportunity to make contributions to traditional and Roth IRAs. However, deductible contributions to traditional IRAs and Roth IRAs are not available to all Americans. The Congress believes that IRAs should be available to more individuals.

The present-law IRA contribution limit has not been increased since 1981. The Committee believes that the limit should be raised in order to allow greater savings opportunities.

The Committee believes it appropriate to expand the types of coins in which IRAs may invest.

Explanation of Provision

Increase in annual contribution limits

The provision increases the annual contribution limit for traditional IRAs and Roth IRAs in

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[7] 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.

$1,000 annual increments, beginning in 2001, until the limit reaches $5,000 in 2003. Thereafter, the limit is indexed for inflation in $100 increments.

Increase in AGI limits for deductible IRA contributions

Under the provision, the AGI phase-out limits for active participants in an employer-sponsored plan is increased annually by $2,000 ($4,000 in the case of married taxpayers filing a joint return) in 2008 and by $2,500 ($5,000 in the case of married taxpayers filing a joint return) in 2009-2010. After 2010, the income limits are indexed for inflation in $1,000 increments. Thus, the phase-out limits are as follows for taxable years beginning in 2008-2010.

Single Returns

Taxable years beginning in:	*Phase-out range*
2008	$52,000-62,000
2009	54,500-64,500
2010	57,000-67,000

Joint Returns

Taxable years beginning in:	*Phase-out range*
2008	$84,000-104,000
2009	89,000-109,000
2010	94,000-114,000

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

AGI limits for Roth IRAs

The provision repeals the Roth IRA contribution AGI phase-out limits. The provision also increases the AGI limit on conversions of traditional IRAs to Roth IRAs to $1 million ($500,000 in the case of a married taxpayer filing a separate return).

IRA investments in coins

The provision allows IRAs to invest in any coin certified by a recognized grading service and traded on a nationally recognized electronic network, or listed by a recognized wholesale reporting service and which (1) is or was at any time legal tender in the United States, or (2) issued under the laws of any State. Such coins must be in the physical possession of the IRA trustee or custodian.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 2000. The increase in the AGI limits for deductible IRA contributions is effective for taxable years beginning after December 31, 2007. The provision increasing the AGI limit for conversions to Roth IRAs is effective for taxable years beginning after December 31, 2002. The provision relating to IRA investment in coins is effective for taxable years beginning after December 31, 1999.

2. Creation of individual development accounts (sec. 303 of the bill and new sec. 530A of the Code)

Present Law

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

Reasons for Change

The Committee recognizes that the rate of private savings in the United States is too low. In particular, many low-income individuals either have inadequate savings or no savings at all. The Committee believes that a tax-subsidized match by financial institutions may help encourage more savings by low-income working individuals. The program is intended to encourage a pattern of individual savings and wealth accumulation. Finally, the Committee believes that the program will allow individuals to use their savings for three important purposes: (1) to afford better educations; (2) to achieve home ownership; and (3) to start their own businesses.

Explanation of Provision

In general

The bill creates individual development accounts ("IDAs") to which eligible individuals can contribute. In addition, the bill provides a tax credit for certain matching contributions made to an IDA by the financial institution maintaining the IDA. Eligible individuals are 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 are allowed to contribute to an IDA. Contributions to IDAs by individuals are not deductible, and earnings on such contributions are includible in income. The maximum contribution that can be made to an IDA for a taxable year is the lesser of (1) $350 or

(2) the individual's taxable compensation for the year. A special rule would allow contributions of up to $350 for each spouse in a married couple if the total compensation of the spouses is at least equal to the amount contributed.

Matching contributions

The bill provides a tax credit to financial institutions that make matching contributions to IDAs of individuals.[8] The tax credit equals 85 percent of matching contributions, rounded up to the nearest $10, up to a maximum annual credit of $300 per eligible individual. The credit is available in each year that a matching contribution is made.

Matching contributions (and earnings thereon) are not 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 contribution is forfeited.[9] Matching contributions may be withdrawn only in a qualified purpose distribution.

A qualified purpose distribution is a distribution (1) that is made after the individual has completed an economic literacy course, (2) that is made by the financial institution directly to the person to whom the funds are to (or to another IDA) and (3) is used for (a) certain educational expenses, (b) first-time homebuyer expenses, and (c) business start-up expenses.

Effect on means-tested programs

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

Effective Date

The provision is 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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[8] Matching contributions (and earnings) are accounted for separately from individual IDA contributions (and earnings).

[9] The financial institution is to use forfeited amounts to make other matching contributions. No credit is provided with respect to such reallocated contributions.

B. Expanding Coverage

1. Option to treat elective deferrals as after-tax contributions (sec. 311 of the bill and new sec. 402A of the Code)

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).[10]

Reasons for Change

The recently-enacted Roth IRA provisions have provided individuals with another form of tax-favored retirement savings. For a variety of reasons, some individuals may prefer to save through a Roth IRA rather than a traditional deductible IRA. The Committee believes that similar savings choices should be available to participants in section 401(k) plans and tax-sheltered annuities.

Explanation of Provision

A section 401(k) plan or a section 403(b) annuity may include a "qualified plus contribution program" that permits 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

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[10] 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 are 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 is 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. Contributions under the qualified plus contribution program must satisfy the requirements of section 401(k) or section 403(b) (other than with respect to the treatment of such contribution as not excludable from income). Thus, for example, designated plus contributions are treated as any other elective deferral for purposes of the nonforfeitability requirements and distribution restrictions of these sections. Under a section 401(k) plan, designated plus contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements. Additionally, designated plus contributions are at all times subject to the requirements of section 401(a)(9) otherwise applicable to any amounts held under a qualified plan.

The plan must 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 is not includible in the participant's gross income. A qualified distribution is 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.[11] The nonexclusion period is 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 is not a qualified distribution. Similarly, a distribution of a designated plus contribution (and income allocable thereto) made to correct a failure of a nondiscrimination test or any other requirement of section 401(a) is not a qualified distribution.

A participant may 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 is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated plus

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

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 provision is effective for taxable years beginning after December 31, 2000.

2. Increase elective contribution limits (sec. 312 of the bill and secs. 402(g), 408(p), and 457 of the Code)

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 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.

Reasons for Change

The tax benefits provided under tax-favored retirement plans are a departure from the normally applicable income tax rules. The special tax benefits for such plans are generally justified on the ground that they serve an important social policy objective, i.e., the provision of retirement benefits to a broad group of employees. The limits on deferrals, in combination with the other limits on contributions, benefits, and compensation that may be taken into account, serve to limit the tax benefits associated with such plans. The level at which to place such limits involves a balancing of different policy objectives and a judgment as to what limits are most likely to best further policy goals.

One of the factors that may influence the decision of an employer, particularly a small employer, to adopt a plan is the extent to which the owners of the business, the decision-makers, or other highly compensated employees will benefit under the plan. The Committee believes that increasing the limits on deferrals will encourage employers to establish tax-favored retirement plans for their employees.

The Committee understands that, in recent years, section 401(k) plans have become increasingly more prevalent. The Committee believes it is important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.

Explanation of Provision

Beginning in 2001, the provision increases 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 provision increases the maximum annual elective deferrals that may 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 are indexed in $500 increments, as under present law.

The provision increases 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 is indexed in $500 increments. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement.[12]

Effective Date

The provision is 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 (sec. 313 of the bill, sec. 4975 of the Code, and secs. 407 and 408 of ERISA)

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.[13] Certain types of transactions are exempted from the prohibited transaction

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[12] Another provision of the provision increases the 33-1/3 percentage of compensation limit to 100 percent.

[13] 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

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 certain transactions in which the plan makes a loan to an owner-employee.[14] Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction 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.

Reasons for Change

The Committee believes that the present-law prohibited transaction rules regarding loans unfairly discriminate against the owners of unincorporated businesses and subchapter S corporations. For example, under present law, the sole shareholder of a C corporation may take advantage of the statutory exemption to the prohibited transaction rules for loans, but an individual who does business as a sole proprietor may not.

Explanation of Provision

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

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substantially similar, although not identical.

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

Effective Date

The provision is effective with respect to loans entered into after December 31, 2000.

4. Elective deferrals not taken into account for purposes of deduction limits (sec. 314 of the bill and sec. 404 of the Code)

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.

Reasons for Change

Subjecting elective deferrals to the normally applicable deduction limits may cause employers to restrict the amount of elective contributions an employee may make or to restrict employer contributions to the plan, thereby reducing participants' ultimate retirement benefits and their ability to save adequately for retirement. The Committee believes that the amount of elective deferrals otherwise allowable should not be further limited through application of the deduction rules.

Explanation of Provision

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

Effective Date

The provision is effective for years beginning after December 31, 2000.

5. Reduce PBGC premiums for small and new plans (secs. 315-316 of the bill and sec. 4006 of ERISA)

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.

Reasons for Change

The Committee believes that reducing the PBGC premiums for new plans will help encourage the establishment of defined benefit pension plans.

Explanation of Provision

Reduced flat-rate premiums for new plans of small employers

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

A small employer is 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 are 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) are taken into account in determining whether the plan is a plan of a small employer.

A new plan means 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 plans

The provision provides 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 is 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 is defined as under the flat-rate premium provision relating to new small employer plans.

Effective Date

The provision is effective for plans established after December 31, 2000.

6. Eliminate IRS user fees for requests regarding new plans (sec. 317 of the bill)

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.[15]

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

Reasons for Change

One of the factors affecting the decision of an employer to adopt a plan is the level of administrative costs associated with the plan. The Committee believes that reducing administrative costs, such as IRS user fees, will help further the establishment of qualified plans by employers.

Explanation of Provision

No user fee is required for any determination letter, ruling, or opinion with respect to a new retirement plan. For purposes of the provision, a new retirement plan is 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 provision is effective for requests made after December 31, 2000.

7. SAFE annuities and trusts (sec. 318 of the bill, new sec. 408B of the Code, and secs. 101 and 4021 of ERISA)

Present Law

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.

Reasons for Change

The Committee believes that the availability of a simplified defined benefit arrangement that does not involve many of the administrative burdens of the present-law qualified plan rules applicable to defined benefit plans will encourage the adoption of defined benefit arrangements by small businesses, thereby leading to increased pension coverage for employees of such businesses.

Explanation of Provision

A small business may establish a simplified retirement plan called the secure assets for employees ("SAFE") plan. The SAFE plan combines the features of a defined benefit plan and a defined contribution plan.

Employer and employee eligibility and vesting

An employer is 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 is eligible to participate. All benefits under a SAFE plan are fully vested at all times.

Benefits and funding

A SAFE plan provides a fully funded minimum defined benefit. For each year of participation, a participant generally accrues a minimum annual benefit at retirement equal to 3 percent of the participant's compensation for the year. The employer may 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 are subject to the annual limitation on compensation that may be taken into account under a qualified plan ($160,000 in 1999).

An employer may 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 is 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 do 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 is 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 may 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 has an account to which actual investment returns are credited. If a participant's account balance is 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 is required to make up the shortfall. If the investment returns in a participant's account exceed the specified interest rate, the participant is entitled to the larger account balance. Permissible investments of a SAFE Trust are 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 is 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 are deductible under the rules applicable to qualified defined benefit plans. An excise tax applies if the employer fails to make the required contribution for the year.

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

Distributions

A SAFE plan may provide for distributions at any time. Distributions from a SAFE plan are 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 are subject to an additional tax equal to 20 percent of the amount distributed.

A SAFE plan must 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 is not subject to the joint and survivor annuity requirements applicable to other defined benefit pension plans.

Nondiscrimination requirements and other rules

A SAFE plan is not 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 apply to SAFE plans.

Effective Date

The provision is effective for years beginning after December 31, 2000.

8. Modification of top-heavy rules (sec. 319 of the bill and sec. 416 of the Code)

Present Law

In general

Under present law, additional qualification requirements apply to plans that primarily benefit an employer's key employees ("top-heavy plans"). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employers and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

In general, a top-heavy plan is a plan under which more than 60 percent of the contributions or benefits are provided to key employees. More precisely, a defined benefit plan is a top-heavy plan if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year ("the determination date").

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the 5-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the 5-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

A key employee is an employee who, during the plan year that ends on the determination date or any of the 4 preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 ($65,000 for 1999), (2) a 5-percent owner of the employer, (3) a 1-percent owner of the employer earning over $150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit ($30,000 for 1999) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1-percent owner status, 5-percent owner status, and largest ownership interests. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2 percent of compensation multiplied by the employee's years of service, or (2) 20 percent of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3 percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).[16]

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) 3-year cliff vesting, which provides for 100 percent vesting after 3 years of service; and (2) 2-6 year graduated vesting, which provides for 20 percent vesting after 2 years of service, and 20 percent more each year thereafter so that a participant is fully vested after 6 years of service.[17]

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a "section 401(k) plan"), an employee may elect to have the employer make payments as contributions to a qualified 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. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the "ADP" test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the "ACP" test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to 3 percent of compensation and (b) 50 percent of the employee's elective deferrals from 3 to 5 percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that

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[16] Tres. Reg. sec. 1.416-1 Q&A M-19.

[17] Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules: (1) 5-year cliff vesting; and (2) 3-7 year graded vesting, which provides for 20 percent vesting after 3 years and 20 percent more each year thereafter so that a participant is fully vested after 7 years of service.

satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

Reasons for Change

The top-heavy rules primarily affect the plans of small employers. While the top-heavy rules were intended to provide additional minimum benefits to rank-and-file employees, the Committee is concerned that in some cases the top-heavy rules may act as a deterrent to the establishment of a plan by a small employer. The Committee believes that simplification of the top-heavy rules will help alleviate the additional administrative burdens the rules place on small employers. The Committee also believes that, in applying the top-heavy minimum benefit rules, the employer should receive credit for all contributions the employer makes, including matching contributions.

The Committee understands that some employers may have been discouraged from adopting a safe harbor section 401(k) plan due to concerns about the top-heavy rules. The Committee believes that facilitating the adoption of such plans will broaden coverage. Thus, the Committee believes it appropriate to provide that such plans are not subject to the top-heavy rules.

Explanation of Provision

Definition of top-heavy plan

The provision provides that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelective contributions provided under such a plan may be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans.[18]

Definition of key employee

The family ownership attribution rule would no longer apply in determining whether an individual is a 5-percent owner of the employer.

Minimum benefit for non-key employees

Under the provision, matching contributions are taken into account in determining whether

[18] This provision is not intended to preclude the use of nonelective contributions that are used to satisfy the safe harbor rules from being used to satisfy other qualified retirement plan nondiscrimination rules, including those involving cross-testing.

the minimum benefit requirement has been satisfied.[19]

Effective Date

The provision is effective for years beginning after December 31, 2000.

[19] Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

C. Enhancing Fairness for Women

1. Additional catch-up contributions (sec. 321 of the bill and secs. 402(g), 408(p), and 457 of the Code)

Present Law[20]

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[21]

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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[20] The various dollar limits on contributions described below increases under other provisions in the provision.

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

Reasons for Change

Although the Committee believes that individuals should be saving for retirement throughout their working lives, as a practical matter, many individuals simply do not focus on the amount of retirement savings they need until they near retirement. In addition, many individuals may have difficulty saving more in earlier years, e.g., because an employee leaves the workplace to care for a family. Some individuals may have a greater ability to save as they near retirement.

The Committee believes that the pension laws should assist individuals who are nearing retirement to save more for their retirement.

Explanation of Provision

The provision provides that individuals who have attained age 50 may 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 provision applies to elective deferrals under a section 401(k) plan, section 403(b) annuity, SIMPLE, or section 457 plan. Additional contributions may 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 provision, the additional amount of elective contributions that may be made by an eligible individual participating in such a plan is 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.[22] The applicable percent is 10 percent in 2001, and increases by 10 percentage points until the applicable percent is 50 in 2005 and thereafter. The following examples illustrate the application of the provision, 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 provision) 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 provision, A is 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

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

compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) 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 provision, 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 provision).

Catch-up contributions made under the provision are not be subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules.[23]

An employer may make matching contributions with respect to catch-up contributions. Any such matching contributions are 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 is increased by 50 percent.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

2. Equitable treatment for contributions of employees to defined contribution plans (sec. 322 of the bill and secs. 403(b), 415, and 457 of the Code)

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

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[23] Another provision in the bill provides that elective contributions are deductible without regard to the otherwise applicable deduction limits.

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.

<u>Section 457 plans</u>

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.

<u>Reasons for Change</u>

The present-law rules that limit contributions to defined contribution plans by a percentage of compensation reduce the amount that non-highly paid workers can save for retirement. The present-law limits may not allow such workers to accumulate adequate retirement benefits, particularly if a defined contribution plan is the only type of retirement plan maintained by the employer.

Conforming the contribution limits for tax-sheltered annuities to the limits applicable to retirement plans will simplify the administration of the pension laws, and provide more equitable treatment for participants in similar types of plans.

Explanation of Provision

Increase in defined contribution plan limit

The provision increases the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent.

Conforming limits on tax-sheltered annuities

The provision repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.

Section 457 plans

The provision increases the 33-1/3 percent of compensation limitation on deferrals under a section 457 plan to 100 percent of compensation.

Effective Date

The provision is effective for years beginning after December 31, 2000.

3. Clarification of tax treatment of division of section 457 plan benefits upon divorce (sec. 323 of the bill and secs. 414(p) and 457 of the Code)

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.

Reasons for Change

The Committee believes that the rules regarding qualified domestic relations orders should apply to all types of employer-sponsored retirement plans.

Explanation of Provision

The provision applies 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 is not treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO.

Effective Date

The provision is effective for transfers, distributions and payments made after December 31, 2000.

4. Modification of safe harbor relief for hardship withdrawals from 401(k) plans (sec. 324 of the bill)

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[24] 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.

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

Reasons for Change

Although the Committee believes that it is appropriate to restrict the circumstances in which an in-service distribution from a 401(k) plan is permitted and to encourage participants to take such distributions only when necessary to satisfy an immediate and heavy financial need, the Committee is concerned about the impact that a 12-month suspension of contributions may have on the retirement savings of a participant who experiences a hardship. The Committee believes that the combination of a 6-month contribution suspension and the other elements of the regulatory safe harbor will provide an adequate incentive for a participant to seek sources of funds other than his or her 401(k) plan account balance in order to satisfy financial hardships.

Explanation of Provision

The Secretary of the Treasury is 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 provision is effective for years beginning after December 31, 2000.

5. Faster vesting of employer matching contributions (sec. 325 of the bill and sec. 411 of the Code)

Present Law

Under present law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent after 4 years of service, 60 percent after 5 years of service, 80 percent after 6 years of service, and 100 percent after 7 years of service.[25]

Reasons for Change

The Committee understands that many employees, particularly lower- and middle-income employees, do not take full advantage of the retirement savings opportunities provided by their

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[25] The minimum vesting requirements are also contained in Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

employer's section 401(k) plan. The Committee believes that providing faster vesting for matching contributions will make section 401(k) plans more attractive for employees, particularly lower- and middle-income employees, and will encourage employees to save more for their own retirement. In addition, faster vesting for matching contributions will enable short-service employees to accumulate greater retirement savings.

Explanation of Provision

The provision applies faster vesting schedules to employer matching contributions. Under the provision, employer matching contributions have to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of 3 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after 6 years of service.

Effective Date

The provision is effective for plan years beginning after December 31, 2000, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

D. Increasing Portability for Participants

1. Rollovers of retirement plan and IRA distributions (secs. 331-333 and 339 of the bill and secs. 401, 402, 403(b), 408, 457, and 3405 of the Code)

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")[26] or another qualified plan.[27] 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.

IRA distributions

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

[27] 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.

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.

Reasons for Change

Present law encourages individuals who receive distributions from qualified plans and similar arrangements to save those distributions for retirement by facilitating tax-free rollovers to an IRA or another qualified plan. The Committee believes that expanding the rollover options for individuals in employer-sponsored retirement plans and owners of IRAs will provide further incentives for individuals to continue to accumulate funds for retirement. The Committee believes it appropriate to extend the same rollover rules to governmental section 457 plans; like qualified plans, such plans are required to hold plan assets in trust for employees.

Explanation of Provision

In general

The provision provides 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.[28] Similarly, distributions from an IRA generally may be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may

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

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 are not required to accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not 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 has to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan are 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 are required to separately account for such amounts.

The provision also provides that benefits in governmental section 457 plans are includible in income when paid.

Rollover of after-tax contributions

The provision provides that employee after-tax contributions may 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 may be accomplished only through a direct rollover. In addition, a qualified plan may 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) may 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 is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

The provision provides that surviving spouses may 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 is 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 provision is effective for distributions made after December 31, 2000.

2. Waiver of 60-day rule (sec. 334 of the bill and secs. 402 and 408 of the Code)

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.

Reasons for Change

The inability of the Secretary to waive the 60-day rollover period can result in adverse tax consequences for individuals. The Committee believes such harsh results are inappropriate and that providing for waivers of the rule will help facilitate rollovers.

Explanation of Provision

The provision provides 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 provision applies to distributions made after December 31, 2000.

3. Treatment of forms of distribution (sec. 335 of the bill and sec. 411(d)(6) of the Code)

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)).[29]

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

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.[30]

Reasons for Change

The Committee understands that the application of the prohibition against the elimination of any optional form of benefit to plan mergers and transfers with respect to defined contribution plans frequently results in complexity and confusion, especially in the context of business acquisitions and similar transactions. In addition, the Committee understands that a defined contribution plan participant who is entitled to receive a single sum distribution generally may roll over such a distribution to an IRA and control the manner of distribution from the IRA.

Explanation of Provision

A defined contribution plan to which benefits are transferred is not 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 is not 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

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

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 is directed to issue, not later than December 31, 2001, final regulations under section 411(d)(6) implementing the provision.

Furthermore, the provision authorizes 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 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 is 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.

Effective Date

The provision is effective for years beginning after December 31, 2000.

4. Rationalization of restrictions on distributions (sec. 336 of the bill and secs. 401(k), 403(b), and 457 of the Code)

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.[31]

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.

Reasons for Change

The Committee believes that application of the "same desk" rule is inappropriate because it hinders portability of retirement benefits, creates confusion for employees, and results in significant administrative burdens for employers that engage in business acquisition transactions.

Explanation of Provision

The provision modifies 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 are repealed; this special rule is no longer necessary under the provision.

Effective Date

The provision is effective for distributions after December 31, 2000. Thus, for example, the provision would apply to a distribution after the effective date without regard to whether the severance from employment upon which the distribution is based occurs before or after the effective date.

5. Purchase of service credit under governmental pension plans (sec. 337 of the bill and secs. 403(b) and 457 of the Code)

Present Law

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

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.

Reasons for Change

The Committee understands that many employees work for multiple State or local government employers during their careers. The Committee believes that allowing such employees to use their section 403(b) annuity and section 457 plan accounts to purchase permissive service credits or make repayments with respect to forfeitures of service credit will result in more significant retirement benefits for employees who would not otherwise be able to afford such credits or repayments.

Explanation of Provision

A participant in a State or local governmental plan is not 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 provision is effective for transfers after December 31, 2000.

6. Employers may disregard rollovers for purposes of cash-out rules (sec. 338 of the bill and sec. 411(a)(11) of the Code)

Present Law

If a 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.[32]

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.[33]

Reasons for Change

The present-law cash-out rule reflects a balancing of various policies. On the one hand is the desire to assist individuals to save for retirement by making it easier to keep retirement funds in tax-favored vehicles. On the other hand is the recognition that keeping track of small account balances of former employees creates administrative burdens for plans.

The Committee is concerned that, in some cases, the cash-out rule may discourage plans from accepting rollovers because the rollover will increase participants' benefits to above the cash-out amount, and increase administrative burdens. The Committee believes that disregarding rollovers for purposes of the cash-out rule will further the intent of the cash-out rule by removing a possible disincentive for plans to accept rollovers.

Explanation of Provision

A plan is 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 provision is effective for distributions after December 31, 2000.

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

[33] Other provisions of the bill 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 (secs. 341 of the bill and secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code)

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)).[34] 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.

Reasons for Change

The Committee is concerned that the current liability full funding limit may result in inadequate funding of pension plans and thus jeopardize pension security. Also, the Committee believes that the special deduction rule should be expanded to give more plan sponsors incentives to adequately fund their plans.

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

[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.

Explanation of Provision

Current liability full funding limit

The provision gradually increases and then repeals the current liability full funding limit. The current liability full funding limit is 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 beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter.

Deduction for contributions to fund termination liability

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., the provision applies to multiemployer plans and plans with 100 or fewer participants. The special rule does not apply to plans not covered by the PBGC termination insurance program.[36]

The provision also modifies 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 does 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 provision is effective for years beginning after December 31, 2000.

2. Extension of PBGC missing participants program (sec. 342 of the bill and secs. 206(f) and 4050 of ERISA)

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

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

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.

Reasons for Change

The Committee recognizes that no statutory provision or formal regulatory guidance exists concerning an appropriate method of handling missing participants in terminated multiemployer plans. Therefore, sponsors of these plans face uncertainty with respect to missing participants. The Committee believes that it is appropriate to extend the established PBGC missing participant program to these plans in order to reduce uncertainty for plan sponsors and increase the likelihood that missing participants will receive their retirement benefits.

Explanation of Provision

The PBGC is directed 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 provision is effective for distributions from terminating plans that occur after the PBGC adopts final regulations implementing the provision.

3. Excise tax relief for sound pension funding (sec. 343 of the bill and sec. 4972 of the Code)

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.[37] 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.

Reasons for Change

The Committee believes that employers should be encouraged to adequately fund their pension plans. Therefore, the Committee does not believe that an excise tax should be imposed on employer contributions that do not exceed the accrued liability full funding limit.

Explanation of Provision

In determining the amount of nondeductible contributions, the employer may 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 are not subject to the excise tax on nondeductible contributions. An employer making such an election for a year may not take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans.

Effective Date

The provision is effective for years beginning after December 31, 2000.

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[37] 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.

4. Notice of significant reduction in plan benefit accruals (sec. 344 of the bill, new sec. 4980F of the Code, and sec. 204(h) of ERISA)

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[38] 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 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.

Reasons for Change

The Committee is aware of recent significant publicity concerning conversions of traditional defined benefit pension plans to "cash balance" plans, with particular focus on the impact such conversions have on affected workers. Legislation has been introduced to address

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

some of the issues relating to such conversions.[39]

The Committee believes that employees are entitled to meaningful disclosure concerning plan amendments that may result in reductions of future benefit accruals. The Committee has determined that present law does not require employers to provide such disclosure, particularly in cases where traditional defined benefit plans are converted to cash balance plans. The Committee also believes that any disclosure requirements applicable to plan amendments should strike a balance between providing meaningful disclosure and avoiding the imposition of unnecessary administrative burdens on employers, and that this balance should include the regulatory process with an opportunity for input from affected parties.

Explanation of Provision

The provision adds 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.[40] The notice must describe 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 will affect different classes of employees. The plan administrator is required to provide the notice not less than 30 days before the effective date of the plan amendment.

The plan administrator must provide this generalized notice to each participant and alternate payee to whom the amendment applies, and to each employee organization representing such individuals. The plan administrator is not 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 provides for a significant change in the manner in which accrued benefits are determined under the plan, or requires an affected participant or affected alternate payee to

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[39] See, e.g., S. 659, introduced by Senator Moynihan on March 18, 1999 (with companion legislation, H.R. 1176 introduced by Congressman Weller, along with Congressmen Bentsen and Ney), and section 407 of H.R. 1102 introduced by Congressman Portman and Congressman Cardin on March 11, 1999. Also, see the Administration's conceptual proposal released by Congressman Matsui (together with Congressman Gejdenson) on July 8, 1999, and the Administration on July 13, 1999.

[40] The provision also modifies 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 provision adds to the Internal Revenue Code.

choose between 2 or more benefit formulas, the plan administrator is 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 provision, an affected participant or alternate payee generally is a participant or alternate payee to whom the significant reduction in the rate of future benefit accrual is 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, is not an affected participant.

An example of an amendment that provides for a significant change in the manner in which accrued benefits are determined is an amendment that replaces a benefit formula that defines a participant's normal retirement benefit as a percentage of the participant's final average compensation with a benefit formula that defines a participant's normal retirement benefit in terms of a hypothetical account credited with annual allocations of contributions and interest. Examples of amendments that do not provide for a significant change in the manner in which accrued benefits are determined are (1) an amendment that reduces the percentage of average compensation that the plan provides as an annual benefit commencing at normal retirement age from 60 percent to 50 percent, and (2) an amendment that modifies the definition of compensation used to determine average compensation by providing for the exclusion of bonuses and overtime.

The plan administrator is required to provide in this additional notice (1) the individual's accrued benefit (and, if the amendment adds 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 is 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 the description of the individual's accrued benefit as of the amendment effective date, an example of determining such benefit under the terms of the plan in effect on the amendment effective date and without regard to the sec. 411(d)(6) protected benefit is a situation in which (1) an amendment replaces a benefit formula that defines a participant's normal retirement benefit as a percentage of the participant's final average compensation with a benefit formula that defines a participant's normal retirement benefit in terms of a hypothetical account credited with annual allocations of contributions and interest, (2) the amendment adds the option of an immediate lump sum distribution, (3) the present value of a participant's sec. 411(d)(6) protected benefit is $50,000, and (4) the beginning balance of the participant's hypothetical account balance under the terms of the plan in effect on the amendment effective date is $25,000.

In this example, the required notice would inform the participant that, as of the amendment effective date, the individual's accrued benefit determined under the terms of the plan in effect immediately before the effective date is $50,000, and the individual's accrued benefit determined under the terms of the plan in effect on the amendment effective date is $25,000.

With respect to a plan amendment that requires an affected participant or affected alternate payee to choose between 2 or more benefit formulas, the Secretary of the Treasury, after consultation with the Secretary of Labor, is 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 Committee does not intend this authorization to result in a modification of the present-law fiduciary requirements under Title I of ERISA.

The provision generally imposes 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 will 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 is authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved. An example of facts and circumstances under which reasonable cause may exist for a failure to comply with the notice requirement is a plan administrator's inability to provide the required generalized notice concerning a plan amendment if the amendment results from a business merger or acquisition transaction and the timing of the transaction prevents the plan administrator from providing the notice at least 30 days prior to the effective date of the amendment.

Effective Date

The provision is effective for plan amendments taking effect on or after the date of enactment. The period for providing any notice required under the provision will 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 will be treated as meeting the requirements of the provision if the plan makes a good faith effort to comply with such requirements. Pending the issuance of regulations, examples of good faith compliance in which the provision would not require additional employee communications include: (1) A plan amendment provides that participants may choose to have their accrued benefits determined under the amended plan formula or under the formula as in effect immediately prior to the amendment effective date, and the plan administrator provides participants with comparison information, including clearly stated assumptions, relative to the amended and prior formulas so that participants are able to make an informed decision; (2) A plan administrator provides to participants estimates of accrued benefits at various career stages, determined under the amended plan formula and under the formula as in effect immediately prior to the amendment effective date, including clearly stated assumptions, and stated as annuities and/or lump sums (without regard to section 417) as appropriate under the plan provisions; (3) An employer informs certain employees before they are hired that the employer's current plan benefit formula will be amended at a specified future date, and these employees participate in the plan under the formula as in effect immediately prior to the amendment until such specified future date (good faith compliance would be relevant for these employees only).

5. Investment of employee contributions in 401(k) plans (sec. 345 of the bill)

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.

Reasons for Change

The Committee believes that the effective date provided in the Taxpayer Relief Act of 1997 with respect to the rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan has produced unintended results.

Explanation of Provision

The provision modifies 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 provision is 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).

6. Modifications to section 415 limits for multiemployer plans (sec. 346 of the bill and sec. 415 of the Code)

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[41] or (2) $30,000 (for 1999). In applying the limits on contributions and benefits, plans of the same employer are aggregated.

Reasons for Change

The Committee understands that, because pension benefits under multiemployer plans are typically based upon factors other than compensation, the section 415 benefit limits frequently result in benefit reductions for employees in industries in which wages vary annually.

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[41] Another provision increases this limit to 100 percent of compensation.

Explanation of Provision

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

The provision also applies the special rules for defined benefit plans of governmental employers to multiemployer plans.

Effective Date

The provision is effective for years beginning after December 31, 2000.

F. Encouraging Retirement Education

1. Periodic pension benefit statements (sec. 351 of the bill and sec. 105 of ERISA)

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.

Reasons for Change

The Committee believes that periodic disclosure concerning the value of retirement benefits, especially the value of benefits accumulating in a defined contribution plan account, is necessary to increase employee awareness and appreciation of the importance of retirement savings.

Explanation of Provision

A plan administrator of a defined contribution plan generally must 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 must either (1) 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) 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 is required to furnish a benefit statement only upon written request of a participant or beneficiary.[42]

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

Effective Date

The provision is effective for plan years beginning after December 31, 2000.

2. Treatment of employer-provided retirement advice (sec. 352 of the bill and sec. 132 of the Code)

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.[43] 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.

Reasons for Change

In order to plan adequately for retirement, individuals must anticipate retirement income needs and understand how their retirement income goals can be achieved. Employer-sponsored plans are a key part of retirement income planning. The Committee believes that employers

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[42] 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)).

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

sponsoring retirement plans should be encouraged to provide retirement planning services for their employees in order to assist them in preparing for retirement.

Explanation of Provision

Under the bill, qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludable from income and wages. The exclusion does 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 qualified plan. The exclusion is intended to allow employers to provide advice and information regarding retirement planning. The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion is not intended to apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 2000.

G. Reducing Regulatory Burdens

1. Flexibility in nondiscrimination and coverage rules (sec. 361 of the bill and secs. 401(a)(4) and 410 of the Code)

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.

Reasons for Change

It has been brought to the attention of the Committee that some plans are unable to satisfy the mechanical tests used to determine compliance with the nondiscrimination and coverage requirements solely as a result of relatively minor plan provisions. The Committee believes that, in such cases, it may be appropriate to expand the consideration of facts and circumstances in the application of the mechanical tests.

Explanation of Provision

The Secretary of the Treasury is directed to provide by regulation applicable to years beginning after December 31, 2000, that a plan is 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 complies 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 provision is effective on the date of enactment.

2. Modification of timing of plan valuations (sec. 362 of the bill and sec. 412 of the Code)

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.

Reasons for Change

While plan valuations are necessary to ensure adequate funding of defined benefit pension plans, they also create administrative burdens for employers. The Committee believes that requiring valuations at least once every three years in the case of well-funded plans strikes an appropriate balance between funding concerns and employer concerns about plan administrative costs.

Explanation of Provision

The provision allows an employer to elect to use the prior year's plan valuation in certain cases. The election may 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 must be adjusted, as provided in regulations, to reflect significant differences in participants. An election made under the provision may be revoked only with the consent of the Secretary. In any event, a plan valuation is required once every three years.[44]

Effective Date

The provision is effective for plan years beginning after December 31, 2000.

3. Rules for substantial owner benefits in terminated plans (sec. 363 of the bill and secs. 4021, 4022, 4043 and 4044 of ERISA)

Present Law

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

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 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.

Reasons for Change

The Committee believes that the present-law rules concerning limitations on guaranteed benefits for substantial owners are overly complicated and restrictive and thus may discourage some small business owners from establishing defined benefit pension plans.

Explanation of Provision

The provision provides that the 60 month phase-in of guaranteed benefits applies 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 depends on the number of years the plan has been in effect. The majority owner's guaranteed benefit is limited so that it may not be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets apply to substantial owners, other than majority owners, in the same manner as other participants.

Effective Date

The provision is 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 (sec. 364 of the bill and sec. 404 of the Code)

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.

Reasons for Change

The Committee believes that it is appropriate to provide incentives for the accumulation of retirement benefits and expansion of employee ownership. The Committee has determined that the present-law rules concerning the deduction of dividends on employer stock held by an ESOP discourage employers from permitting such dividends to be reinvested in employer stock and accumulate for retirement purposes.

Explanation of Provision

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 is 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 provision is effective for taxable years beginning after December 31, 2000.

5. Notice and consent period regarding distributions (sec. 365 of the bill and sec. 417 of the Code)

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 and the consent of the participant's spouse 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.[45]

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

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, and (2) in certain cases, the right, if any, to defer receipt of the distribution. In addition, the plan must provide to the participant notice 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. If the joint and survivor annuity requirements apply to the participant, the plan must provide to the participant 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 these 3 notices 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.

Reasons for Change

The Committee understands that an employee is not always able to evaluate distribution alternatives, select the most appropriate alternative, and notify the plan of the selection within a 90-day period. The Committee believes that requiring a plan to furnish multiple distribution notices to an employee who does not make a distribution election within 90 days is administratively burdensome. In addition, the Committee believes that participants who are entitled to defer distributions should be informed of the impact of a decision not to defer distribution on the taxation and accumulation of their retirement benefits.

Explanation of Provision

A qualified retirement plan is 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 is 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 right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

Effective Date

The provision is effective for years beginning after December 31, 2000.

6. Repeal transition rule relating to certain highly compensated employees (sec. 366 of the bill and sec. 1114(c)(4) of the Tax Reform Act of 1986)

Present Law

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee[46] 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.

Reasons for Change

The Committee believes that it is appropriate to repeal the special definition of highly compensated employee in light of the substantial modification of the general definition of highly compensated employee in the Small Business Job Protection Act of 1996.

Explanation of Provision

The provision repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition applies.

Effective Date

The provision is effective for plan years beginning after December 31, 1999.

7. Employees of tax-exempt entities (sec. 367 of the bill)

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

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

prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

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.[47]

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

Reasons for Change

The Committee believes that it is appropriate to modify the special rule regarding the treatment of certain employees of a tax-exempt organization as excludable for section 401(k) plan nondiscrimination testing purposes in light of the provision of the Small Business Job Protection Act of 1996 that permits such organizations to maintain section 401(k) plans.

Explanation of Provision

The Treasury Department is directed 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 will be effective for years beginning after December 31, 1996.

Effective Date

The provision is effective on the date of enactment.

8. Extension to international organizations of moratorium on application of certain nondiscrimination rules applicable to State and local government plans (sec. 368 of the bill, sec. 1505 of the Taxpayer Relief Act of 1997, and secs. 401(a) and 401(k) of the Code)

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

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.

Reasons for Change

The Committee believes that application of the nondiscrimination and minimum participation rules to plans maintained by tax-exempt international organizations is unnecessary and inappropriate in light of the unique circumstances under which such plans and organizations operate.

Explanation of Provision

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

Effective Date

The provision is effective for plan years beginning after December 31, 2000.

9. Annual report dissemination (sec. 369 of the bill and sec. 104 of ERISA)

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.

Reasons for Change

The Committee believes that simplification of the summary annual report requirement will reduce the burden and cost of plan administration and disclosure, thereby encouraging more employers to establish and maintain retirement plans, without denying participants the opportunity to obtain information concerning plan status and operation.

Explanation of Provision

Within 9 months after the end of each plan year, the plan administrator is 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 is required to furnish the summary to a participant, or to a beneficiary receiving benefits under the plan, upon request.

Effective Date

The provision is effective for reports for years beginning after December 31, 1998.

10. Clarification of exclusion for employer-provided transit passes (sec. 370 of the bill and sec. 132 of the Code)

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).

Reasons for Change

The Committee believes that the present-law voucher rule relating to transit benefits unduly restricts the use of cash reimbursement for such benefits compared to other types of qualified transportation benefits. In addition, the Committee understands that some employers are concerned about the administrative interpretation of the present-law rules, and may be discouraged from providing such benefits because of the costs and administrative burdens involved in obtaining vouchers or due to concerns that the IRS will disqualify their reimbursement programs. The Committee believes that transit benefits should not be subject to more restrictive rules than other transportation fringe benefits, and that the provision of transit benefits should be encouraged.

Explanation of Provision

The provision repeals 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 provision is effective for taxable years beginning after December 31, 1999.

H. Provisions Relating to Plan Amendments (sec. 371 of the bill)

Present Law

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

Reasons for Change

The Committee believes that employers should have adequate time to amend their plans to reflect amendments to the law.

Explanation of Provision

Any amendments to a plan or annuity contract required to be made by the provision are not 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 is extended to the first plan year beginning on or after January 1, 2005.

Effective Date

The provision is effective on the date of enactment.

TITLE IV. EDUCATION TAX RELIEF

A. Eliminate Marriage Penalty and 60-Month Limit on Student Loan Interest Deduction (sec. 401 of the bill and sec. 221 of the Code)

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.[48] 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.

Reasons for Change

The Committee believes that the income phaseouts for the student loan interest deduction are too low and should be raised. In addition, the Committee is concerned about the inequity of the marriage penalty resulting from the phase-out provisions of the student loan interest deduction. The Committee believes that relief from the marriage penalty is appropriate for individuals with education loan obligations in order to assist in removing tax considerations from decisions regarding marriage.

The Committee also understands that many students incur considerable debt in the course of obtaining undergraduate and graduate education. The Committee believes that it is appropriate to

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

expand the deduction for individuals who have paid interest on qualified education loans by repealing the limitation that the deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. In addition, the repeal of the 60-month limitation lessens complexity and administrative burdens for taxpayers, lenders, loan servicing agencies, and the Internal Revenue Service.

Explanation of Provision

The bill increases 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 bill increases 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 will 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.

The bill also repeals 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 provision is effective generally for taxable years ending after December 31, 1999. The provision repealing the 60-month limit on deductible student loan interest is effective for interest paid on qualified education loans after December 31, 1999, in taxable years ending after such date.

B. Allow Tax-free Distributions From State and Private Education Programs (sec. 402 of the bill and sec. 529 of the Code)

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[49], 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.[50]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.[51] 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

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

[50] 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.

[51] 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.

government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account 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).

Reasons for Change

The Committee is concerned about the costs of higher education and believes that families should be encouraged to save for those expenses. Accordingly, the Committee has determined that distributions from qualified tuition programs should be exempt from Federal income tax to the extent that such distributions are used to pay for qualified higher education expenses of undergraduate or graduate students who are attending institutions of higher education or certain vocational schools. In addition, the Committee believes that families would benefit from an expansion of the present-law rules governing qualified tuition programs so as to permit private educational institutions to maintain certain prepaid tuition programs. The Committee also believes that additional modifications are necessary to enhance the effectiveness of the program.

Explanation of Provision

Qualified tuition program

The bill expands 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 will be able to purchase tuition credits or certificates on behalf of a designated beneficiary (as described in section 529(b)(1)(A)(i)), but will not be able to make contributions to a savings account plan (described in section

529(b)(1)(A)(ii)).

Exclusion from gross income

Under the bill, an exclusion from gross income is 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 is 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 bill also allows 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.[52]

Definition of qualified higher education expenses

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[52] In determining the amount of a distribution that can be excluded from income for a taxable year, a taxpayer's total higher education expenses will be reduced first by the amount of such expenses which were taken into account in determining the amount of any HOPE or Lifetime Learning credit allowed to the taxpayer (or other person) with respect to such expenses. After any reduction for expenses allocable to the credits, taxpayers may determine how to allocate their qualified education expenses among the various remaining education provisions (including education individual retirement accounts and qualified tuition programs) for which they are eligible; however, under no circumstances, can the same expenses be allocated to more than one provision. For example, suppose that in 2002, a college freshman withdraws funds from both an education IRA and a qualified tuition program. If the student is otherwise eligible, he or she may claim a HOPE credit of $1,500 with respect to first $2,000 of tuition expense. To the extent that the student's remaining educational expenses constitute "qualified higher education expenses" and exceed the amounts distributed from both the education IRA and the qualified tuition program, the student may exclude from gross income the earnings portions (and, as always, the principal portions) of both distributions. Alternatively, if after allocating the first $2,000 of tuition expense to the HOPE credit, the student's remaining educational expenses do not exceed his or her total distributions from the education IRA and qualified tuition program, the student will not be able to exclude from gross income the entire earnings portions of both distributions. In addition, the student may be liable for a penalty imposed under the qualified tuition program or for additional tax imposed on the excess amounts distributed from the education IRA, or both. The student may allocate his or her educational expenses between the distributions as the student determines appropriate, but may not use the same expenses for both distributions, nor may he or she "reuse" the expenses that were taken into account in order to claim the HOPE credit.

Under the bill, the definition of "qualified higher education expenses" is 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 bill also provides 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 bill does not change the definition of "qualified higher education expenses" with respect to expenses for room and board.

Rollovers for benefit of same beneficiary

The bill clarifies 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 bill provides 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 provision permitting the establishment of qualified tuition programs maintained by one or more private educational institutions is 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 is 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 provision allowing an exclusion from gross income for certain distributions is effective for distributions made in taxable years beginning after December 31, 2003. The provision coordinating distributions from qualified tuition programs and education individual retirement accounts with the HOPE and Lifetime Learning credits is effective for distributions made after December 31, 1999. The provision modifying the definition of qualified higher education expenses is effective for amounts paid for courses beginning after December 31, 1999. The provisions allowing rollovers for the same beneficiary and including first cousins as a member of the family is 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 (sec. 403 of the bill and sec. 117 of the Code)

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.

Reasons for Change

The Committee believes that it is appropriate to provide tax-free treatment for scholarships received by students under the NHSC Scholarship Program and Armed Forces Scholarship Program.

Explanation of Provision

The bill provides that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are 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 does not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The provision is 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 (sec. 404 of the bill and sec. 127 of the Code)

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.[53] 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.[54]

Reasons for Change

The Committee believes that the exclusion for employer-provided educational assistance

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

[54] 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.

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

The Committee believes that reinstating the exclusion for graduate-level employer-provided educational assistance will enable more individuals to seek higher education. Such education can increase individuals' job opportunities and help make America more competitive in the global market place.

The past experience of allowing the exclusion to expire and subsequently retroactively extending it has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. For employers, the fits and starts of the legislative history of the provision have caused severe administrative problems. The Committee believes that uncertainty about the exclusion's future may discourage some employers from providing educational benefits.

Explanation of Provision

The provision makes the exclusion for employer-provided educational assistance permanent. The provision also extends the exclusion to graduate education, effective for courses beginning on or after January 1, 2000.

Effective Date

The provision is generally effective on the date of enactment. The exclusion with respect to graduate-level courses is effective for courses beginning on or after January 1, 2000.

E. Liberalization of Tax-exempt Financing Rules for Public School Construction (secs. 405 - 407of the bill and secs. 103 and 148 of the Code)

Present Law

1. 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.

<u>Restriction on Federal guarantees of tax-exempt bonds</u>

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 other Federal insurance programs that were in existence when the restriction was enacted.

2. 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.

Reasons for Change

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. The exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. The Committee believes that a limited increase of $5 million per year for public school construction bonds will more accurately conform this present-law exception to current school construction costs.

Further, the Committee wishes to encourage public-private partnerships to improve educational opportunities. To permit public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing, the Committee determined that is appropriate to allow the issuance of tax-exempt private activity bonds for public school facilities.

Finally, the Committee believes it is appropriate to foster public school construction by permitting the Federal Home Loan Bank Board to satisfy its present-law community development requirements in a more cost-effective manner -- by guaranteeing tax-exempt bonds for such construction.

Explanation of Provisions

1. 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 is increased from $5 million to $10 million. Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures.

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

The private activities for which tax-exempt bonds may be issued are 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 term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events)[55]and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system

[55] The present-law limit on the amount of the proceeds of a private activity bond issue that may be used to finance land acquisition does not apply to these bonds.

of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes or equips a school facility. The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate 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. As with the present-law State private activity bond volume limits, States decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

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

The Federal Housing Finance Board is permitted to authorize the regional Federal Home Loan Banks in its system to guarantee limited amounts of public school bonds. Eligible bonds are governmental bonds with respect to which 95 percent of more of the proceeds are used for public school construction. The aggregate amount of bonds which may be guaranteed by all such Banks pursuant to this provision is $500 million per year. The provision only modifies the Internal Revenue Code; it does not modify the relevant provisions of the United States Code which govern activities of the Federal Housing Finance Board and the Federal Home Loan Banks.

Effective Dates

These provisions relating arbitrage rebate requirements for public school bonds are effective for bonds issued after December 31, 1999.

The provision relating to guarantees of public school construction bonds will become effective upon enactment (after the date of enactment of the bill) of legislation authorizing the Federal Housing Finance Board and Federal Home Loan Banks to provide the guarantees permitted under the bill.

TITLE V. HEALTH CARE TAX RELIEF PROVISIONS

A. Above-the-Line Deduction for Health Insurance Expenses (sec. 501 of the bill and new sec. 222 of the Code)

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.

Reasons for Change

The Committee believes that the present-law inequities in tax treatment of health insurance expenses should be reduced. In addition, the Committee believes that providing an additional incentive for the purchase of health insurance for those who pay for most of their health insurance on an after-tax basis will encourage uninsured individuals to purchase health insurance for themselves and their families.

Explanation of Provision

The provision provides 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.[56] The deductible percentage is: 25 percent in 2001, 2002, and 2003; 50 percent in 2004 and 2005; and 100 percent in 2006 and thereafter.[57]

The deduction is not 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.[58] For purposes of this rule, any amounts excludable from the gross income of the employee under the exclusion for employer-provided health coverage is 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 is considered to be paid for by the employer.[59]

Except as provided below, in determining whether the 50-percent threshold is met, all health plans of the employer in which the employee participates are 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 is available only with respect to each plan with respect to which the employer subsidy is less than 50 percent. Cost is determined as under the health care continuation rules.

The deduction is not available with respect to insurance providing coverage for accidents, disability, dental care, vision care, or a specific disease or making payments of a fixed amount per day (or other period) on account of hospitalization. In addition, insurance providing such coverage (and employer payments for such coverage) are not taken into account for purposes of the 50-percent rule.

The following examples illustrate the application of the 50-percent rule.

Example 1: Employee A participates in an employer-sponsored health plan. The annual

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[56] The deduction only applies to health insurance that constitutes medical care; it does not apply to medical expenses. The deduction applies 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. As described below, the bill provides a similar deduction for qualified long-term care insurance expenses.

[57] The deduction is not available with respect to any amounts excludable from gross income, e.g., salary reduction contributions used to purchase health insurance under a cafeteria plan.

[58] This rule is applied separately with respect to qualified long-term care insurance.

[59] Excludable employer contributions to a health flexible spending arrangement or medical savings account (including salary reduction contributions) are also considered amounts paid by the employer for health insurance that constitutes medical care. Salary reduction contributions are not considered to be amounts paid by the employee.

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 is not 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 $one-half of the cost of this plan. The second plan provides only dental insurance. The cost of the dental plan is $300 per year, which is paid by the employee. In determining whether B is entitled to the deduction, the dental plan is disregarded. Thus, the total cost of the health plans in which B participates is $2,000. The employer pays for 50 percent of this total cost. B may not deduct her share of the premium for the major medical plan, nor the cost of the dental insurance.

Example 3: Employee C participates in an employer-sponsored health plan. The cost of the plan is $4,000. The employer pays $1,000 of the cost of the plan directly, and Employee C pays the remainder of the $3,000 cost of the plan by salary reduction through a cafeteria plan. The $1,000 employer contribution and the $3,000 salary reduction contributions are all employer payments. Thus, the employer pays for the entire cost of the plan, and the deduction is not available.

The deduction is not available to individuals enrolled in Medicare, Medicaid, the Federal Employees Health Benefit Program ("FEHBP"),[60] Champus, VA, Indian Health Service, or Children's Health Insurance programs. Thus, for example, the deduction is not available with respect to Medigap coverage, because such coverage is provided to individuals enrolled in Medicare.

The provision authorizes the Secretary to prescribe rules necessary to carry out the provision, including appropriate reporting requirements for employers.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

[60] This rule does not prevent individuals covered by the FEHBP from deducting premiums for health care continuation coverage, provided the requirements for the deduction are otherwise met.

B. Provisions Relating to Long-Term Care Insurance
(secs. 501 and 502 of the bill, new sec. 222 of the Code and secs. 106 and 125 of the Code)

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.[61]

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.

Reasons for Change

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") included provisions providing favorable tax treatment for qualified long-term care insurance. The Congress enacted those provisions in order to provide an incentive for individuals to take financial responsibility for their long-term care needs. The Committee believes that further incentives are appropriate for individuals to purchase their own qualified long-term care insurance. The Committee also wishes to facilitate the purchase of qualified long-term care insurance through the workplace.

Explanation of Provision

Deduction for qualified long-term care insurance expenses

The provision provides 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.[62] The deductible percentage is: 25

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

[62] The deduction applies only 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

percent in 2001, 2002, and 2003; 50 percent in 2004 and 2005; and 100 percent in 2006 and thereafter.[63]

The deduction is not 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.[64] For purposes of this rule, any amounts excludable from the gross income of the employee with respect to qualified long-term care insurance are treated as paid or incurred by the employer. In determining whether the 50-percent threshold is met, all plans of the employer providing long-term care in which the employee participates are 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 is available only with respect to each plan with respect to which the employer pays for less than 50 percent of the cost. Cost is determined as under the health care continuation rules.

The provision authorizes the Secretary to prescribe rules necessary to carry out the provision, including appropriate reporting requirements for employers.

Provision of long-term care in a cafeteria plan

The provision provides that qualified long-term care insurance is a qualified benefit under a cafeteria plan, to the extent that the insurance is treated as a medical expense under the itemized deduction for medical expenses (i.e., to the extent the qualified long-term care insurance does not exceed the premium limitations under sec. 213). The provision also provides that qualified long-term care services may be provided under an FSA.[65]

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

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bill provides a similar deduction for health insurance expenses.

[63] The deduction is not available with respect to any amounts excludable from gross income, e.g., salary reduction contributions used to purchase qualified long-term care insurance under a cafeteria plan.

[64] This rule is applied separately with respect to health insurance.

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

C. Additional Personal Exemption for Caretakers
(sec. 503 of the bill and sec. 151 of the Code)

Present Law

Present law does not provide 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 citizenship 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. For 1999, 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.

Reasons for Change

Present law provides favorable tax treatment for long-term care insurance and services, but does not provide similar tax relief for in-home care. The Committee understands that in-home care may be preferable in some cases, and that individuals who care for family members with special needs incur additional expenses. Thus, the Committee believes tax relief for in-home care is appropriate.

Explanation of Provision

The bill provides taxpayers who maintain a household including one or more "qualified persons" with an additional personal exemption for each qualified person.

A "qualified person "is an individual who: (1) satisfies a relationship test, (2) satisfies a residency test, (3) satisfies an identification test, and (4) has been certified as having long-term care needs. The individual satisfies 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 are treated as a father or mother for these purposes.

An individual satisfies 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 satisfies the identification test if the individual's name and taxpayer identification number ("TIN") is included on the taxpayer's return for the taxable year.

In order to be a qualified individual, an individual must be certified before the due date of the return for the taxable year (without extensions) by a licensed physician as having long-term care needs for period which is at least 180 consecutive days and a portion of which occurs within the taxable year. The certification must be made no more than 39-1/2 months before the due date for the return (or within such other period as the Secretary has prescribed).

Under the provision, an individual has long-term care needs if the individual is unable 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 are: (1) eating; (2) toileting; (3) transferring; (4) bathing; (5) dressing; and (6) continence. Substantial assistance includes 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 is considered to have long-term care needs if he or she (1) requires substantial supervision for at least 6 months to be protected from threats to health and safety due to severe cognitive impairment and (2) is 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.

The bill provides that a taxpayer is treated as maintaining a household for any period only if over one-half of the cost of maintaining the household for such period is furnished by such taxpayer or, if such taxpayer is married, by such taxpayer and the taxpayer's spouse. The bill also provides 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 bill provides that a taxpayer legally separated from his or her spouse under a decree of divorce or of separate maintenance will not be considered married for purposes of this provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

D. Add Certain Vaccines Against Streptococcus Pneumoniae to the List of Taxable Vaccines (sec. 504 of the bill and secs. 4131 and 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines recommended for routine 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 applied 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 ("Vaccine 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 and physicians. 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.

Reasons for Change

Streptococcus pneumoniae (often referred to as pneumococcus) is a bacteria that can cause bacterial meningitis, a brain or spinal cord infection, bacteremia, a bloodstream infection, and otitis media (ear infection). The Committee understands that each year in the United States, pneumococcal disease accounts for an estimated 3,000 cases of bacterial meningitis, 50,000 cases of bacteremia, 500,000 cases of pneumonia, and 7 million cases of otitis media among all age groups. The Committee understands that, while there currently is a vaccine effective in preventing pneumococcal diseases in adults, that vaccine, a polysaccaride vaccine, does not induce an adequate immune response in young children and therefore does not protect children against these diseases. The Committee further understands that the Food and Drug Administration's (the "FDA") is expected to approve a new, sugar protein conjugate vaccine against the disease and the Centers for Disease Control is expected to recommend this conjugate vaccine for routine inoculation of children. The Committee believes American children will benefit from wide use of this new vaccine. The Committee believes that, by including the new vaccine with those presently covered by the Vaccine Trust Fund, greater application of the vaccine will be promoted. The Committee, therefore, believes it is appropriate to add the conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines.

The Committee is aware that the Vaccine Trust Fund has a current cash-flow surplus in excess of $1.3 billion dollars.[66] The Committee, therefore, feels it is appropriate to reduce the rate of tax applied to all vaccines. However, the Committee thinks it is prudent to gather more detailed information on the operation of the Vaccine Injury Compensation Program and likely future claims to assess the adequacy of the Vaccine Trust Fund. Therefore, the Committee finds it appropriate to direct the Comptroller General of the United States to report on the operation and management of expenditures from the Vaccine Trust Fund and to advise the Committee on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

<u>Explanation of Provision</u>

The bill adds any conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines. The bill also changes 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 bill also reduces 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 bill directs the General Accounting Office ("GAO") 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 Trust Fund and to advise the Committees on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

Within its report, to the greatest extent possible, the Committee would like to see a thorough statistical report of the number of claims submitted annually, the number of claims settled annually, and the value of settlements. The Committee would like to learn about the statistical distribution of settlements, including the mean and median values of settlements, and the extent to which the value of settlements varies with an injury attributed to an identifiable vaccine. The Committee also would like to learn about the settlement process, including a statistical distribution of the amount of time required from the initial filing of a claim to a final resolution.

The Code provides that certain administrative expenses may be charged to the Vaccine Trust Fund. The Committee intends that the GAO report include an analysis of the overhead and administrative expenses charged to the Vaccine Trust Fund.

The GAO is directed to report its findings to the House Committee on Ways and Means and the Senate Committee on Finance within one year of the date of enactment.

<u>Effective Date</u>

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[66] Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (as of January 1, 1999)* (JCS-2-99), March 29, 1999, p. 48.

The provision is 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 pneumonia vaccines to children. No floor stocks tax is to be collected for amounts held for sale on that date. For sales on or before the date on which the Centers for Disease Control make final recommendation for routine administration of conjugate streptococcus pneumonia vaccines to children for which delivery is made after such date, the delivery date is deemed to be the sale date. The addition of conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines is contingent upon the inclusion in this legislation of the modifications to Public Law 105-277.

The provision 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. For the purpose of determining the amount of refund of tax on a vaccine returned to the manufacturer or importer, for vaccines returned after August 31, 2004 and before January 1, 2005, the amount of tax assumed to have been paid on the initial purchase of the returned vaccine is not to exceed $0.25 per dose.

TITLE VI. SMALL BUSINESS TAX RELIEF PROVISIONS

A. Accelerate 100-Percent Self-Employed Health Insurance Deduction (sec. 601 of the bill and sec. 162(l) of the Code)

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.

Reasons for Change

The Committee believes it appropriate to eliminate the disparate treatment of employer-provided health care and health insurance expenses of self-employed individuals as soon as possible.

Explanation of Provision

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

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

B. Increase Section 179 Expensing
(sec. 602 of the bill and sec. 179 of the Code)

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.

Reasons for Change

The Committee believes that section 179 expensing provides two important benefits for small business. First, it lowers the cost of capital for tangible property used in a trade or business. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these benefits, the Committee bill increases the amount allowed to be expensed under section 179 to $30,000.

Explanation of Provision

The provision provides 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 provision is effective for taxable years beginning after December 31, 1999.

C. Repeal of Temporary Federal Unemployment Surtax (sec. 603 of the bill and sec. 3301 of the Code)

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4-percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States currently 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.

Reasons for Change

Because current projections indicate that the overall funding levels in the unemployment trust funds can be maintained at adequate levels without the 0.2-percent surtax, the Committee believes that the surtax should be repealed. Also, the Committee believes that the repeal will reduce the tax burden on businesses subject to the surtax.

Explanation of Provision

The bill repeals the temporary FUTA surtax after December 31, 2004.

Effective Date

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

D. Coordinate Farmer Income Averaging and the Alternative Minimum Tax (sec. 604 of the bill and sec. 55 of the Code)

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.

Reasons for Change

The Committee believes that farmer income averaging should be coordinated with the alternative minimum tax so that a farmer's alternative minimum tax liability is not increased solely because he or she elects income averaging.

Explanation of Provision

The provision coordinates farmer income averaging with the alternative minimum tax. A farmer electing to average his or her farm income will owe alternative minimum tax only to the extent he or she would have owed alternative minimum tax had averaging not been elected. This is 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 provision is effective for taxable years beginning after December 31, 1999.

E. Farm and Ranch Risk Management Accounts (sec. 605 of the bill and sec. 468C of the Code)

Present Law

There is no provision in present law allowing the elective deferral of farm income.

Reasons for Change

The Committee believes that farmers should be encouraged to set aside a portion of their earnings during good years to provide for their support during those future years when they may be less successful.

Explanation of Provision

The bill allows taxpayers engaged in an eligible farming business to establish Farm and Ranch Risk Management (FARRM) accounts. An eligible farming business is any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting of crop-bearing or ornamental trees[67].

Contributions to a FARRM account are deductible and are limited to 20 percent of the taxable income that is attributable to the eligible farming business. The deduction is to be taken into account in determining adjusted gross income and will reduce income attributable to farming for all purposes other than the determination of the 20 percent of eligible farm income limitation on contributions to a FARRM account. Contributions will be deemed to have been made on the last day of the taxable year if made on or before the due date (without regard to extensions) of the taxpayer's return for that year.

A FARRM account is taxed as a grantor trust and any earnings are required to be distributed currently. Thus, any income earned in the FARRM account is taxed currently to the farmer who established the account.

Contributions to a FARRM account do not reduce earnings from self-employment. Accordingly, distributions are not included in self-employment income.

Amounts may remain on deposit in a FARRM account for five years. Any amount that has not been distributed by the close of the fourth year following the year of deposit is deemed to be distributed and includible in the gross income of the account owner. Distributions for the year are considered to first be made from the earnings that are required to be distributed. Additional amounts distributed for the year are considered to be made from the oldest deposits.

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[67] An evergreen tree that is more than 6 years old when severed from the roots (and thus eligible for captial gains treatment on cutting) is not considered an ornamental tree for this purpose.

A FARRM account may not be maintained by a taxpayer who has ceased to engage in an eligible farming business. If the taxpayer does not engage in an eligible farming business during two consecutive taxable years, the balance in the FARRM account is deemed to be distributed to the taxpayer on the last day of such two year period.

If the taxpayer who established the FARRM account dies, and the taxpayer's surviving spouse acquires the taxpayer's interest in the FARRM account by reason of being designated as the beneficiary of the account at the death of the taxpayer, the surviving spouse will "step into the shoes" of the deceased taxpayer with respect to the FARRM account. In other cases, the account will cease to be a FARRM account on the date of the taxpayer's death and the balance in the account will be deemed distributed to the taxpayer on the date of death.

A FARRM account is a trust that is created or organized in the United States for the exclusive benefit of the taxpayer who establishes it. The trustee must be a bank or other person who demonstrates to the satisfaction of the Secretary that it will administer the trust in a manner consistent with the requirements of the section. At all times, the assets of the trust must consist entirely of cash and obligations which have adequate stated interest (as defined in section 1274(c)(2)) and which pay such adequate interest not less often than annually. The trust must distribute all income currently, and its assets may not be commingled except in a common trust fund or common investment fund. Additional protections, including rules preventing the trust from engaging in prohibited transactions or from being pledged as security for a loan, are provided.

Penalties apply in the case of excess contributions and failures to make required distributions.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

TITLE VII. ESTATE AND GIFT TAX RELIEF

A. Reduce Estate, Gift, and Generation-Skipping Transfer Taxes (secs. 701-702 of the bill and secs. 2001 and 2010 of the Code)

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 (indexed beginning in 1999).

Reasons for Change

The Committee believes that the estate, gift, and GST taxes are unduly burdensome on all taxpayers. The Committee, therefore, believes it is appropriate to lessen the estate, gift, and GST tax burden on taxpayers.

Explanation of Provision

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

Effective Date

The 5-percent surtax and the rates in excess of 50 percent are repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2000. The unified credit is replaced with a unified exemption for estates of decedents dying and gifts made after December 31, 2003. The unified exemption amount is 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 (sec. 711 of the bill and sec. 2031 of the Code)

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.

Reasons for Change

The Committee believes that expanding the availability of qualified conservation easements will further ease existing pressures to develop or sell environmentally significant land in order to raise funds to pay estate taxes and would, thereby, advance the preservation of such land. The Committee also believes it appropriate to clarify the date for determining easement compliance.

Explanation of Provision

The bill expands the availability of qualified conservation easements by increasing from

25 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 bill also clarifies that the date for determining easement compliance is the date on which the donation was made.

Effective Date

The provision clarifying the date for determining easement compliance is effective for estates of decedents dying after December 31, 1997. The provision expanding the distance rule is effective for estates of decedents dying after December 31, 1999.

C. Increase Annual Gift Exclusion (sec. 721 of the bill and sec. 2503 of the Code)

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.

Reasons for Change

The gift tax annual exclusion was increased in 1981, from $3,000 to $10,000 for each donee.[68] Moreover, notwithstanding the inflation adjustment provided for gifts made in a calendar year after 1998,[69] the Committee finds that the benefit of the annual exclusion has eroded over time. Thus, the Committee believes that the amount of the gift tax annual exclusion should be increased.

Explanation of Provision

The gift tax annual exclusion for each donee is increased as follows: to $12,000 for 2001, to $13,500 for 2002, to $15,000 for 2003, to $16,500 for 2004, to $18,000 for 2005, and to $20,000 for 2006.

Effective Date

The annual gift tax exclusion is increased as follows: to $12,000, for each donee, for gifts made after December 31, 2000, but before January 1, 2002; to $13,500 for gifts made after December 31, 2001, but before January 1, 2003; to $15,000 for gifts made after December 31, 2002, but before January 1, 2004; to $16,500 for gifts made after December 31, 2003, but before January 1, 2005; to $18,000 for gifts made after December 31, 2004, but before January 1, 2006, and to $20,000 for gifts made after December 31, 2005, and thereafter.

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[68] P.L. 97-34 (August 13, 1981).

[69] Sec. 2503(b)(2); P.L. 105-34 (August 5, 1997).

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

1. Retroactive allocation of the GST tax exemption (sec. 731 of the bill and sec. 2632 of the Code)

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 (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 likely will 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.

Reasons for Change

The Committee recognizes that when a transferor does not expect a beneficiary in the second generation (e.g., the transferor's child) to die before the termination of a trust, the transferor likely will not allocate GST tax exemption to the transfer to the trust. If a transferor knew, however, that the transferor's child might predecease the transferor and that there could be a taxable termination as a result thereof, the transferor likely would have allocated GST tax exemption at the time of the transfer to the trust. The Committee believes it is appropriate to provide that when there is an unnatural order of death (e.g., when a beneficiary in the second generation dies before the first generation transferor), the transferor may allocate GST tax exemption retroactively to the date of the respective transfer to trust.

Explanation of Provision

The bill allows 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 provision permits 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 is allocated under this rule retroactively, and the applicable fraction and inclusion ratio are determined based on the value of the property on the date the property was transferred to a trust.

Effective Date

The provision applies 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 (sec. 732 of the bill and sec. 2642 of the Code)

Present Law

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in 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 ratio 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 establish inclusion ratios of zero and one by severing a trust that is subject to the GST tax after the trust has been created.

Reasons for Change

If a trust has an inclusion ratio between zero and one, every distribution from the trust is subject to tax at a reduced rate. Complexity in this regard can be reduced if a GST trust is treated as two separate trusts for GST tax purposes–one with an inclusion ratio of zero and one with an inclusion ratio of one. This result can be achieved by drafting complex documents in order to meet the specific requirements of severance. The Committee believes it is appropriate to make the rules regarding severance less burdensome and less complex.

Explanation of Provision

The bill allows 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 provision, a trustee may elect to sever a trust in a qualified severance at any time.

Effective Date

The provision is effective for severances of trusts occurring after the date of enactment.

3. Modification of certain valuation rules (sec. 733 of the bill and sec. 2642 of the Code)

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.

Reasons for Change

The Committee believes it is appropriate to clarify the valuation rules relating to timely and automatic allocations of GST tax exemption.

Explanation of Provision

The bill provides 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 is effective as though included in the amendments made by section 1431 of the Tax Reform Act of 1986.

4. Relief from late elections (sec. 734 of the bill and sec. 2642 of the Code)

Present Law

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 the 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.

Reasons for Change

The Committee believes it is appropriate for the Treasury Secretary to grant extensions of time to make an election to allocate GST tax exemption and to grant exceptions to the statutory time requirement in appropriate circumstances, e.g., when the taxpayer intended to allocate GST tax exemption and the failure to timely allocate GST tax exemption was inadvertent.

Explanation of Provision

The bill authorizes and directs 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) is treated as if not expressly prescribed by statute.

Effective Date

The provision to provide relief from late elections applies to requests pending on, or filed after, the date of enactment.[70]

5. Substantial compliance (sec. 734 of the bill and sec. 2642 of the Code)

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.

Reasons for Change

The Committee recognizes that the rules and regulations regarding the allocation of GST tax exemption are complex. Thus, it is often difficult for taxpayers to comply with the technical requirements for making a proper election to allocate GST tax exemption. The Committee therefore believes it is appropriate to provide that GST tax exemption will be allocated when a taxpayer substantially complies with the rules and regulations for allocating GST tax exemption.

Explanation of Provision

The bill provides that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption is sufficient to establish that GST tax exemption was allocated to a particular transfer or a particular trust. 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 are effective on the date of enactment and 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

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

has not expired.[71]

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

TITLE 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 (sec. 801 of the bill and sec. 501(c)(28) of the Code)

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 or accruing to a State or any political subdivision thereof.

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

Health coverage for high-risk individuals

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.

Reasons for Change

The Committee understands that certain types of insurance to support governmental programs to prepare for or mitigate the effects of natural catastrophic events (such as hurricanes) may be limited or unavailable at reasonable rates in the authorized insurance market in some States. The Committee believes it is appropriate to provide tax-exempt status to certain types of associations that provide property and casualty insurance for property located within a State if the State has determined that coverage in the authorized insurance market is in fact limited or unavailable at reasonable rates.

Explanation of Provision

The provision provides 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 provision, 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 (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. The provision requires 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. The provision requires 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, the provision requires 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 provision provides 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 provision, 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 provides 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 provision, from which it receives such remittances. The election is 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 provision, and would be effective as of the effective date of that determination.

An organization described in the provision is 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 provision, no income or gain is recognized solely as a result of the change in status to that of an association exempt from tax under the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999. No inference is intended as to the tax status under present law of associations described in the provision.

B. Modify Section 512(b)(13)
(sec. 802 of the bill and section 512(b)(13) of the Code)

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 includible 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).

Reasons for Change

The Committee believes that the present-law rule of section 512(b)(13) produces results that are arbitrary in certain cases and that it is appropriate to use a fair market value standard to determine the pricing structure for rents, royalties, interest, and annuities paid by subsidiaries to their tax-exempt parent organizations.

Explanation of Provision

The bill provides 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) is included in the parent organizations's UBI. The bill also imposes an addition to tax of 20 percent of the excess amount of any such payment.

The bill provides relief for payments under contracts which, on the date of enactment of the proposal, are still 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 provision 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 applies to payments received or accrued after December 31, 1999.

C. Simplify Lobbying Expenditure Limitations (sec. 803 of the bill and secs. 501(h) and 4911 of the Code)

Present Law

An organization 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, its expenditures, or both.[72]

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

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

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 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.

Reasons for Change

The Committee believes that the rules governing lobbying expenditures by public charities should be simplified by eliminating the separate expenditure limitation on grass roots lobbying.

Explanation of Provision

The bill removes the separate percentage limitation on grass roots lobbying expenditures. Consequently, public charities are subject to an expenditure limitation only on their total lobbying expenditures.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

D. Tax-Free Withdrawals From IRAs for Charitable Purposes (sec. 804 of the bill and sec. 408(d) of the Code)

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.

Reasons for Change

The Committee believes it appropriate to facilitate the making of charitable contributions from IRAs.

Explanation of Provision

The provision provides 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 applies 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 character of distributions from a charitable remainder annuity trust or a charitable remainder unitrust to which a qualified charitable distribution from an IRA was made, the charitable remainder trust is required to treat as ordinary income the portion of the distribution from the IRA to the trust which would have been includible in income but for the provision, and as corpus any remaining portion of the distribution. 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 is not 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 is any distribution from an IRA which is made after age 70-1/2, which qualifies as a charitable contribution (within the meaning of sec. 170(c)), and which is made directly to the charitable organization or to a charitable remainder annuity trust, charitable remainder unitrust, pooled income fund, or charitable gift annuity (as described above).[73] A taxpayer is not permitted to claim a charitable contribution deduction for amounts transferred from his or her IRA to charity or to a trust, fund, or annuity that, because of the provision, are excluded from the taxpayer's income.

Effective Date

The provision is effective with respect to distributions after December 31, 2000.

[73] The Committee intends that, in the case of transfer to a trust, fund, or annuity, the full amount distributed from an IRA will meet the definition of a qualified charitable distribution if the charitable organization's interest in the distribution would qualify as a charitable contribution under section 170.

E. Provide Exclusion for Mileage Reimbursements by Charitable Organizations (sec. 805 of the bill and new sec. 138A of the Code)

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)).[74] 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.

Reasons for Change

The Committee believes that it is important to recognize the valuable contributions made by volunteers to charitable organizations by providing an exclusion from income up to the applicable business rate for volunteers who receive reimbursements for the costs of using their automobiles while performing services for charitable organizations.

Explanation of Provision

Under the bill, 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

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[74] 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).

connection with providing donated services is 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 expenditures for which a volunteer is reimbursed must be expenditures for which a deduction would otherwise be allowable under section 170. The bill does 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

The provision is effective for taxable years beginning after December 31, 1999.

F. Charitable Contribution Deduction for Certain Expenses in Support of Native Alaskan Subsistence Whaling (sec. 806 of the bill and sec. 170 of the Code)

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.

Reasons for Change

The Committee believes it is appropriate to provide a charitable contribution deduction up to $7,500 per year for certain expenses incurred by individuals engaging in sanctioned subsistence whaling activities.

Explanation of Provision

The bill allows 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 is 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 deduction is available 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 provision, the term "sanctioned whaling activities" means subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo Whaling Commission. No inference is intended regarding the deductibility of any whaling expenses incurred in a taxable year ending before January 1, 2000.

Effective Date

The provision is effective for taxable years ending after December 31, 1999.

G. Charitable Giving Provisions
(secs. 807-809 of the bill and secs. 170 and 63 of the Code)

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.[75]

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)).

Reasons for Change

The Committee believes that it is appropriate to provide additional incentives for individuals and corporations to make contributions to charitable organizations.

Explanation of Provision

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

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[75] 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.

The bill allows 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, a calendar-year taxpayer may make a contribution to a qualifying school on March 23, 2001, and claim a charitable contribution deduction for that gift on his or her Federal income tax return for the year 2000 filed on April 15, 2001.[76] For purposes of the provision, a low-income school is 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 bill allows taxpayers who do not itemize their deductions to claim a deduction for charitable contributions in addition to the standard deduction. The deduction is limited to $50 for individual taxpayers and $100 for taxpayers filing joint returns.

Increase AGI percentage limits for individuals

The bill phases up the percentage limitations applicable to charitable contributions of cash and capital gain property to public charities and certain other charitable entities (organizations and entities described in section 170(b)(1)(A)) by individuals. Beginning in 2002, the bill increases the 50-percent and 30-percent limitations by 2 percent per year until the limitations are equal to 60 percent and 30 percent, respectively, in 2006. In 2007, the limitations are increased to 70 percent and 50 percent, respectively.

Increase AGI percentage limits for corporations

The bill phases up the percentage limitation applicable to charitable contributions by corporations. Beginning in 2002, the bill increases the 10-percent limitation by 2 percent per year until the limitation is equal to 20 percent in 2006.

Effective Date

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

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

H. Modify Excess Business Holdings Rules for Publicly Traded Stock (sec. 810 of the bill and Code sec. 4943)

Present Law

Private foundations, which are charitable organizations that do not qualify as public charities, are subject to certain restrictions on their operations. Violations of these restrictions may subject the foundation and, in some cases, their foundation managers to excise taxes. One such restriction prohibits a private foundation from owning more than specified equity interests in business enterprises, including corporations, partnerships, estates, or trusts (sec. 4943). A private foundation, together with all disqualified persons, generally may not hold more than 20 percent of a corporation's voting stock, a partnership's profits interest, or similar interest in a business enterprise.[77] The limit increases to 35 percent if effective control of the business is in the hands of one or more persons who are not disqualified persons. These rules do not apply if the foundation owns less than 2 percent of a business, or if the business engages in activities that are substantially related to the foundation's charitable purpose.

If a foundation acquires business holdings other than by purchase (i.e., by gift or bequest), and the holdings would result in the foundation having excess business holdings, the foundation effectively has five years to reduce those holdings to permissible levels. In the case of an unusually large gift or bequest, the initial five-year disposition period may be extended by the Internal Revenue Service for an additional five years if the foundation is able to demonstrate that it has made diligent efforts to dispose of the excess holdings within the initial five-year period and that disposition within that period was not possible (except at a price substantially below fair market value) because of the size and complexity or diversity of the holdings.

The initial tax imposed on a foundation with excess business holdings is 5 percent of the value of such holdings during the taxable year. The amount of tax is computed with respect to the greatest amount of excess business holdings during the taxable year. If the foundation fails to divest itself of the excess holdings within a certain period of time, an additional tax equal to 200 percent of their value is imposed on the excess business holdings remaining at the end of the period.

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[77] A disqualified person is a person (including an individual, corporation, partnership, trust, or estate) that has a particularly influential relationship with respect to a private foundation. Disqualified persons include: (1) substantial contributors to a foundation (e.g., the founder of a foundation); (2) foundation managers (officers, directors, or trustees of a foundation, or an individual having powers or responsibilities similar to these positions); (3) persons who own more than a 20 percent interest in an entity (corporation, partnership, trust, or other unincorporated enterprise) that is a disqualified person with respect to a foundation; (4) family members of persons described in (1), (2), and (3); (5) corporations, partnerships, trusts, or estates that are more than 35 percent owned by persons described in (1), (2), (3), and (4); (6) only for purposes of the excess business holdings rules, certain private foundations; and (7) only for purposes of the self-dealing rules of section 4943, government officials at certain levels.

Present law also prohibits transactions between private foundations and disqualified persons by imposing excise taxes when disqualified persons engage in acts of "self-dealing" with a private foundation (sec. 4941). Acts of self-dealing include any direct or indirect: (1) sale, exchange, or leasing of property between a private foundation and a disqualified person, (2) lending of money or extensions of credit between a private foundation and a disqualified person,[78] (3) furnishing of goods, services, or facilities between a private foundation and a disqualified person,[79] (4) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person,[80] (5) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation, and (6) agreement by a private foundation to make any payment of money or other property to a government official. There is no exception from the prohibition on acts of self-dealing for inadvertent violations, and even transactions which arguably may benefit the private foundation may be subject to tax as an act of self-dealing. Thus, for example, a disqualified person may not rent space to a private foundation at a rate that is below the market.

Self-dealing excise taxes are imposed on a disqualified person who has engaged in a self-dealing transaction, and on any foundation manager who knowingly participates in the transaction.[81]

Reasons for Change

The Committee believes it is appropriate to increase the limit applicable to business holdings by a private foundation in certain limited circumstances.

Explanation of Provision

The bill would provide an exception to the excess business holdings rules of section 4943

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[78] The lending of money to private foundation on an interest-free basis where the loan proceeds are to be used exclusively for charitable purposes is not an act of self-dealing.

[79] A disqualified person may, however, furnish goods, services, or facilities to a private foundation at no charge. In addition, it is not an act of self-dealing for a private foundation to furnish goods, services, or facilities to a disqualified person on a basis no more favorable than available to the general public.

[80] Payment by a private foundation of compensation to a disqualified person (other than a government official) for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation is not an act of self-dealing.

[81] Except in the case of a government official, the excise tax is imposed on a disqualified person even though the person had no knowledge at the time of the act that it constituted self-dealing. In the case of a government official, however, the tax may be imposed only if the official participated in an act of self-dealing knowing that it was such an act.

in certain circumstances. Under the bill, a private foundation and all disqualified persons are permitted to own up to 49 percent of the voting stock and 49 percent in value of all outstanding shares of all classes of stock in an incorporated business enterprise if the stock held by the foundation and disqualified persons is publicly traded stock for which market quotations are readily available.

The bill limits the extent to which disqualified persons with respect to the foundation can engage in transactions with up to 49-percent owned corporations. Disqualified persons are not permitted to receive compensation from the corporation or to engage in any act with the corporation that would constitute self-dealing under section 4941 if the corporation were a private foundation and the disqualified persons were disqualified persons with respect to such corporation. Disqualified persons may not own, in the aggregate, more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock in such corporation. Finally, an audit committee of the board of directors (consisting of a majority of persons who are not disqualified persons) of each corporation that is up to 49-percent owned by a private foundation must certify in writing to the foundation that the committee is not aware, after due inquiry, that any disqualified person has received compensation from the corporation or has engaged in an act of self-dealing with the corporation. This certification must be filed by the private foundation with its annual information return.

Effective Date

The provision is effective for foundations established by bequest of decedents dying after December 31, 2006.

TITLE IX. INTERNATIONAL TAX RELIEF PROVISIONS

A. Allocate Interest Expense on Worldwide Basis
(sec. 901 of the bill and sec. 864 of the Code)

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

In general

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.

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)).

Reasons for Change

The present-law rules with respect to the allocation and apportionment of interest expense, although largely left to Treasury regulations, are generally based on the principle that money is fungible and that interest expense is properly attributable to all business activities and property of the taxpayer, regardless of the specific purpose for which the debt is incurred. The present-law rules, however, do not take into account the interest expense of foreign affiliates. Accordingly, the interest expense incurred by the domestic members of an affiliated group is treated as funding all the activities and assets of such group, including the assets and activities of the group's foreign affiliates, notwithstanding that the foreign affiliate may have directly incurred debt itself to fund its own assets and activities.

The Committee believes that ignoring the interest expense of foreign affiliates in the interest expense allocation and apportionment formula can result in a disproportionate amount of U.S. interest expense being allocated to foreign-source income, which in turn could result in an inappropriate reduction in the group's foreign tax credit limitation. To the extent that the interest expense allocation rules are intended to apply the principle of fungibility, the Committee believes that the rules should take into account the interest expense incurred by and assets owned by foreign affiliates. While foreign affiliates' borrowings are not related to the amount of the U.S. group's interest deduction, the Committee believes that those borrowings may nonetheless bear on the proper allocation of the U.S. group's interest expense for foreign tax credit purposes.

The Committee believes that both domestic corporations and foreign corporations which satisfy the 80-percent vote and value standards of affiliation for consolidated return purposes are sufficiently economically interrelated that treatment as a single corporation for interest expense allocation purposes provides an accurate measurement of their economic income.

Present law treats certain banks and bank holding companies as a separate subgroup of the affiliated group to which the interest expense allocation rules apply separately. This separation recognizes that financial institutions may have debt structures that are very different from the other, nonfinancial members of an affiliated group. The Committee believes that the same rationale applies to any corporations predominantly engaged in banking, insurance, financing, and similar businesses and not merely those entities regulated as U.S. banks. The Committee therefore believes that affiliated groups should be permitted to apply the interest expense allocation rules separately with respect to a subgroup consisting of all corporations predominantly engaged in such financial services businesses.

Explanation of Provision

In general

The bill modifies the present-law interest expense allocation rules (which generally apply for purposes of computing the foreign tax credit limitations) 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 interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis. The election provides 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 is expanded to include foreign corporations that satisfy the requirements for affiliation but are excluded under section 1504(b)(3) (i.e., foreign corporations in which at least 80 percent of the total vote and value of the stock of such corporations is owned by one or more members of the affiliated group). In addition, if a taxpayer elects to be governed by the new worldwide fungibility principle, the bill provides an additional one-time election to apply the worldwide fungibility principle to a separate subgroup of the worldwide affiliated group consisting of all members that are predominantly engaged in a financial services business.

Worldwide affiliated group election

Under the bill, the common parent of an affiliated group can make a one-time election to apply the present-law interest expense allocation and apportionment rules under section 864(e) by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group on a worldwide-group basis. If an affiliated group makes this election, subject to certain modifications and exceptions discussed below, the taxable income of the domestic members of the worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bear to the total assets of the worldwide affiliated group, over (2) the interest expense incurred by a foreign member of the group to the extent that such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.[82]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group (as that term is defined under present law for interest expense allocation purposes)[83] as well as any foreign corporations that would be

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[82] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[83] The bill expands the present-law definition of an affiliated group for interest expense allocation purposes with respect to an electing worldwide affiliated group to include certain

members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). In short, the taxable income from sources outside the United States of electing domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A) as modified to include insurance companies) and 80-percent or greater owned foreign corporations were attributable to a single corporation.

The general rules under present law continue to 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 continues to be made on the basis of assets (rather than gross income), modified to include a foreign member's assets. In addition, as is the case under present law, certain basis adjustments are made with respect to the stock of nonaffiliated 10-percent owned corporations. To the extent that foreign members are included in the worldwide affiliated group, these basis adjustments are not applicable.

The worldwide affiliated group election is to be made by the common parent of the affiliated group. It must be made for the first taxable year beginning after December 31, 2003 (the effective date), in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election is made and all subsequent taxable years.

Financial institution group election

The bill provides a "financial institution group" election that expands the bank group rules of present law (sec. 864(e)(5)(B)-(D)). At the election of the common parent of the affiliated group that has made the election to apply the worldwide affiliated group rules, those rules can be applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the present-law bank group and (2) all "financial corporations." For this purpose, a corporation is a financial corporation 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)[84] that is derived from transactions with unrelated persons.

The financial institution group rules, if elected, apply to all members of the worldwide

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insurance companies that are generally excluded from an affiliated group under section 1504(b)(2) (without regard to whether such companies are covered by an election under section 1504(c)(2)). As is the case under present law, the affiliated group includes section 936 corporations.

[84] See Treas. Reg. sec. 1.904-4(e)(2).

affiliated group that are financial corporations within the meaning of the provision. The election must be made for the first taxable year beginning after December 31, 2003, in which a worldwide affiliated group includes a financial corporation that would qualify as part of the expanded financial institution group (other than a corporation that would qualify as part of the present-law bank group). Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years.

It is intended that Treasury regulations, similar to those that apply to the present-law bank group, would continue to apply to treat the financial institution group as a segregated group from the rest of the affiliated group.[85] Thus, the measurement of assets of the worldwide affiliated group would exclude the stock of members included in the financial institution group and, similarly, the financial institution group would not take into account the stock of any lower-tier corporation that is a member of the worldwide affiliated group but not a member of the financial institution group.

In addition, the bill provides anti-abuse rules under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. In this regard, if a member of an electing financial institution group makes dividend or other distributions in a taxable year to a member of the worldwide affiliated group (other than a member of the financial institution group) that exceed the greater of (1) its average annual dividend (expressed as a percentage of current earnings and profits) during the five preceding taxable years or (2) 25 percent of its average annual earnings and profits for such five preceding taxable years, or otherwise deals with any person in a manner not clearly reflecting income (as determined under principles similar to section 482), an amount of the financial institution group's indebtedness equal to such excess is recharacterized as indebtedness of the broader worldwide affiliated group (excluding the financial institution group).

Regulatory authority

The bill grants the Treasury Secretary authority to prescribe rules to carry out the purposes of the provision, 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 present law); (2) to prevent assets and interest expense from being taken into account more than once; and (3) to provide for the direct allocation of interest expense in circumstances where such allocation would be appropriate to carry out the purposes of the provision, including, for example, circumstances in which interest expense is incurred by foreign corporations in order to circumvent the purposes of the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 2003 .

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[85] Temp. Treas. Reg. sec. 1.861-11T(d)(4).

B. Look-Through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations (sec. 902 of the bill and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that 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").[86] 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.

Reasons for Change

In the Taxpayer Relief Act of 1997, the Congress provided for a look-through regime to apply in characterizing dividends from 10/50 companies for foreign tax credit limitation purposes. The present-law rules that subject the dividends received from each 10/50 company to a separate foreign tax credit limitation impose a substantial record-keeping burden on companies and have

[86] 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.

the additional negative effect of discouraging minority-position joint ventures abroad.[87]

The Committee believes that the present-law rules for dividends from 10/50 companies will result in additional complexity and compliance burdens. For instance, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, will be subject to the concurrent application of both the single-basket approach (for pre-2003 earnings and profits) and the look-through approach (for post-2002 earnings and profits).

The Committee believes that joint ventures can be an efficient way for U.S. businesses to exploit their know-how and technology in foreign markets. To the extent that the present-law limitation is discouraging such joint ventures or altering the structure of new ventures, the ability of U.S. businesses to succeed abroad could be diminished. The Committee believes that it is important to simplify the look-through approach enacted in 1997.

Explanation of Provision

The bill simplifies 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 bill eliminates the single-basket limitation approach for dividends from such companies for foreign tax credit limitation purposes.

The bill provides 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 bill, look-through principles similar to those applicable to post-effective date dividends from a 10/50 company apply to determine the appropriate foreign tax credit limitation category or categories with respect to the foreign tax credit carryforward.

The bill also provides 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 (or in which the income is not treated as falling within one of certain enumerated limitation categories). In such cases, the bill treats the dividend (or a portion thereof) from such 10/50 company as a dividend that is not subject to the look-through rules.

The bill provides the Treasury Secretary with authority to prescribe regulations regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of the stock to which the distributions relate. The regulations may address, for example, the treatment of pre-acquisition earnings and profits and related foreign income taxes of a 10/50 company, including distributions from a controlled foreign corporation out of earnings and profits for periods when it was not a controlled foreign corporation.

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[87] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 302.

Effective Date

The provision is 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 (secs. 903 and 904 of the bill and sec. 954 of the Code)

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).

Reasons for Change

The subpart F rules generally apply to provide current U.S. taxation of income that can be described as "mobile," that is, income for which the taxpayer might easily be able to arrange that it be sourced to a low-tax foreign jurisdiction. The Committee understands that, until recently, many countries did not permit foreign corporations to own energy facilities such as oil and gas pipelines, electric generating stations, and high voltage electricity transmission lines. The Committee observes that with the advent of deregulation policies abroad, many U.S. corporations are actively considering the construction and operation of oil and gas pipelines and high voltage electricity transmission systems in foreign markets. The Committee understands that such projects involve substantial amounts of fixed capital investment, the income from which does not represent the type of “mobile” income to which the subpart F rules should apply.

Explanation of Provision

The bill exempts 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 does not constitute foreign base company services income. No inference is intended as to the treatment of such income under present law.

The bill also provides an additional exception to the definition of foreign base company oil related income. Under the bill, foreign base company oil related income does 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 exception applies whether or not the CFC that owns the pipeline also owns any interest in the oil or gas transported. In addition, the exception applies 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 provision is 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 (sec. 905 of the bill and secs. 6103 and 6110 of the Code)

Present Law

Section 6103

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

The Code defines return information 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 this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.[88]

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.[89] It also provides judicial and administrative procedures to resolve disputes over

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

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

the scope of the information the IRS will disclose. In addition, Congress has also wholly exempted certain matters from section 6110's public disclosure requirements.[90] Any part of a written determination or background file that is not disclosed under section 6110 constitutes "return information."[91]

The Freedom of Information Act (FOIA) lists categories of information that a federal agency must make available for public inspection.[92] It establishes a presumption that agency records 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.[93] 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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[90] Sec. 6110(l).

[91] 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").

[92] 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.

[93] 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.[94] If section 6110 covers the written determination, then the public cannot use the FOIA to obtain that determination.

Advance Pricing Agreements

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.[95] 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.[96] On January 11, 1999, the IRS conceded that APAs are "rulings" and therefore are "written determinations" for purposes of section 6110.[97] Although the court has not yet issued a

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[94] Sec. 6110(m).

[95] BNA v. IRS, 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 . . ."

[96] 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.

[97] 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.

Reasons for Change

The APA program has been a successful mechanism for resolving transfer pricing issues, not only for future years, but, in some instances, for prior open years as well (rollbacks). It reduces protracted disputes and costly litigation between taxpayers and the government. The program involves not only taxpayers and the IRS, but also foreign taxing authorities.

As part of the program, the taxpayer voluntarily provides substantial, sensitive information to the IRS. The proprietary information necessary to support a claim of comparability may be among a company's most closely guarded trade secrets. Similarly, information regarding production costs and customer pricing may also be extremely sensitive information.

From the program's inception, the IRS has assured taxpayers and foreign governments that the information received or generated in the APA process would be protected as confidential return information. Such assurances were based on published IRS materials.

The APA process is based on taxpayers' cooperation and voluntary disclosure to the IRS of sensitive information. The continued confidentiality of this information is vital to the APA program. Otherwise, the Committee believes that some taxpayers may refuse to participate in this successful program, causing a decline in its usefulness.

Congress must balance the need for confidentiality with the general public's need for practical tax guidance. Some members of the public have expressed concern that the APA program has led to the development of a body of "secret law," known only to a few members of the tax profession. In addition, some members of the public contend that taxpayers have received APAs permitting the use of transfer pricing methodologies not contemplated in the section 482 regulations. They also contend that APAs have provided interpretations of law not available to taxpayers that do not participate in the APA process. Such concerns could undermine the public's confidence in the IRS's ability to fairly enforce the transfer pricing rules. Thus, the provision requires the Department of the Treasury to prepare and publish an annual report regarding APAs, which will provide extensive information regarding the program, while clarifying that existing and future APAs and related background information continue to be confidential return information.

Explanation of Provision

The bill amends section 6103 to provide that APAs and related background information are confidential return information under section 6103. Related background information is meant to include: the request for an APA, any material submitted in support of the request, and any communication (written or otherwise) prepared or received by the Secretary in connection with an APA, regardless of when such communication is prepared or received. Protection is not limited to agreements actually executed; it includes material received and generated in the APA process that does not result in an executed agreement.

Further, APAs and related background information are not "written determinations" as that term is defined in section 6110. Therefore, the public inspection requirements of section 6110 do not apply to APAs and related background information. A document's incorporation in a background file, however, is not intended to be grounds for not disclosing an otherwise disclosable document from a source other than a background file.

The bill statutorily requires that the Treasury Department prepare and publish an annual report on the status of APAs. The annual report is to 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 to date and for the year;
- The number of APA renewals issued to date and 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, to date and for the year;
- The number of finalized new APAs and renewals by industry;[98] and

General descriptions of:

- the nature of the relationships between the related organizations, trades, or businesses covered by APAs;
- the related organizations, trades, or businesses whose prices or results are tested to determine compliance with the transfer pricing methodology

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

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 and/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 is to cover the period January 1, 1991, through the calendar year including the date of enactment. The Treasury Department cannot include any information in the report which would have been deleted under section 6110(c) if the report were a written determination as defined in section 6110. Additionally, the report cannot include any information which can be associated with or otherwise identify, directly or indirectly, a particular taxpayer. The Secretary is expected to obtain input from taxpayers to ensure proper protection of taxpayer information and, if necessary, utilize its regulatory authority to implement appropriate processes for obtaining this input. For purposes of section 6103, the report requirement is treated as part of Title 26.

The IRS user fee otherwise required to be paid for an APA is increased by $500. The Secretary has the authority to make appropriate reductions in such fee for small businesses.

While the bill statutorily requires an annual report, it 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 provision is effective on the date of enactment; accordingly, no APAs, regardless of whether executed before or after enactment, or related background file documents can be released to the public after the date of enactment. It requires the Treasury Department to publish the first annual report no later than March 30, 2000.

E. Exempt Certain Sales of Frequent-Flyer and Similar Reduced-Fare Air Transportation Rights from Aviation Excise Taxes (sec. 906 of the bill and sec. 4261 of the Code)

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, subject to an exception for rights actually used for purposes other than air transportation (as determined under Treasury Department regulations), the tax 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.

Reasons for Change

The Committee observes that present law requires the Internal Revenue Service to collect air passenger transportation excise taxes related to the right to so-called “frequent flyer” travel from both U.S. persons and foreign persons with a nexus to the United States. The Committee is concerned that, in practice, compliance and payment of the excise tax will be greater among U.S. persons than among foreign persons. Such an outcome could place U.S. persons who market such frequent flyer programs at a disadvantage with foreign persons who market similar programs when offering such programs to foreign customers.

The current authority granted to the Treasury Department to exempt certain awards does not permit an exemption unless the rights actually are used for a purpose other than air transportation (e.g., hotels or car rentals). Thus, under present law, rights are taxable even if transportation for which they ultimately are used has no nexus to the United States. The Committee believes that it is appropriate to exempt rights that are unlikely to have a nexus to the United States.

Explanation of Provision

The provision exempts 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 are those listed on the records of the operator of the frequent-flyer or similar program.

Effective Date

The provision applies to air transportation rights sold after December 31, 1999.

F. Repeal of Limitation of Foreign Tax Credit under Alternative Minimum Tax (sec. 907 of the bill and sec. 59 of the Code)

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The maximum rate for noncorporate taxpayers is 28 percent. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI.[99] Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to total AMTI (sec. 59(a)(4)).

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit. For example, assume that a corporation has $10 million of AMTI from foreign sources, has no AMT net operating loss or energy preference deductions, and is subject to the AMT. In the absence of the AMT foreign tax credit, the corporation's tax liability would be $2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below $200,000. Any unused AMT foreign tax credit may be carried back 2 years and carried forward 5 years for use against AMT in those years under the principles of the foreign tax credit carryback and carryforward rules set forth in section 904(c).

Reasons for Change

The purpose of the foreign tax credit generally is to eliminate the possibility of double taxation (once by the foreign jurisdiction and again by the United States) on the foreign source income of a U.S. person. The Committee believes, however, that the 90-percent limitation on the AMT foreign tax credit has the effect of double taxing such income for AMT taxpayers. For

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[99] Similar to the regular tax foreign tax credit, the AMT foreign tax credit is subject to the separate limitation categories set forth in section 904(d). Under the AMT foreign tax credit, however, the determination of whether any income is high taxed for purposes of the high-tax-kick-out rules (sec. 904(d)(2)) is made on the basis of the applicable AMT rate rather than the highest applicable rate of regular tax.

example, if the taxpayer in the above example had $10 million of AMTI from foreign sources (and no AMT net operating loss or energy preference deductions) and was subject to the AMT for six successive years, even with the carryforward under present law, the taxpayer would lose $200,000 worth of foreign tax credits and effectively would be double taxed on such income. The Committee believes that the present-law 90-percent limitation imposes inappropriate double taxation.

Explanation of Provision

The bill repeals the 90-percent limitation on the utilization of the AMT foreign tax credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 2004.

G. Treatment of Military Property of Foreign Sales Corporations (sec. 908 of the bill and sec. 923 of the Code)

Present Law

A portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. In general, the term "foreign trading gross receipts" means the gross receipts of a FSC from the sale or lease of export property, services related and subsidiary to the sale or lease of export property, engineering or architectural services for construction projects located outside the United States, and certain managerial services for an unrelated FSC or DISC.

Section 923(a)(5) contains a special limitation relating to the export of military property. Under regulations prescribed by the Treasury Secretary, the portion of a FSC's foreign trading gross receipts from the disposition of, or services relating to, military property that may be treated as exempt foreign trade income is limited to 50 percent of the amount that would otherwise be so treated. For this purpose, the term "military property" means any property that is an arm, ammunition, or implement of war designated in the munitions list published pursuant to federal law.[100] Under this provision, the export of military property through a FSC is accorded one-half the tax benefit that is accorded to exports of non-military property.

Reasons for Change

The Committee finds the present-law rule limiting the tax benefit available for the export of property through a FSC to one half of that otherwise available in the case of the export of military property to be an inappropriate limitation. The Committee believes that exporters of military property should be treated no differently under the FSC rules than exporters of other products.

Explanation of Provision

The bill repeals the special FSC limitation relating to the export of military property, thus providing exports of military property through a FSC with the same treatment currently provided exports of non-military property.

Effective Date

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[100] Section 923(a)(5) defines "military property" by reference to section 995(b)(3)(B), which contains a technical error. Section 995(b)(3)(B) references the Military Security Act of 1954. The proper reference should have been to the Mutual Security Act of 1954, which subsequently was superceded by the International Security Assistance and Arms Export Control Act of 1976. Current Treasury regulations provide the correct reference for purposes of defining "military property."

The provision is effective for taxable years beginning after December 31, 2004.

TITLE X. HOUSING AND REAL ESTATE TAX RELIEF

A. Increase Low-Income Housing Tax Credit Per Capita Amount (sec. 1001 of the bill and sec. 42 of the Code)

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.[101] 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

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[101] 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.

pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

Each State annually receives low-income housing credit authority equal to $1.25 per State resident for allocation to qualified low-income projects.[102] 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;[103] (2) the amount of the State housing credit ceiling (if any) returned in the calendar year;[104] 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.

Reasons for Change

The Committee believes that the credit acts as a stimulus for low-income housing. However, it believes that the $1.25 credit cap, which has remained the same since 1986, needs to be adjusted for the increased costs of producing such housing. Also, the Committee believes that

[102] 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.

[103] 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.

[104] 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.

the creation of a State floor will work better than a simple per-capita rule for States with small populations. It believes that the expansion of the credit cap will allow the construction and substantial rehabilitation of more affordable rental housing for low-income individuals in the future.

Explanation of Provision

The bill makes several changes to the low-income housing credit. First, the $1.25 per capita cap for each State modified so that small population State are given a minimum of $2 million of annual credit cap. Second, the $1.25 per capita element of the credit cap is increased to $1.75 per capita. This increase is phased-in by increasing the credit cap by 10 cents per capita each year for five years. Therefore the credit cap will be: $1.35 per capita or $2 million, whichever is greater, in calendar year 2001; $1.45 per capita or $2 million, whichever is greater, in calendar 2002; $1.55 per capita or $2 million, whichever is greater, in calendar year 2003; $1.65 per capita or $2 million, whichever is greater, in calendar year 2004; and $1.75 per capita or $2 million, whichever is greater, in calendar year 2005 and thereafter. Third, the stacking rule is modified so that each State is treated as using its allocation of the unused State housing credit ceiling (if any) from the preceding calendar year 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 provision is effective for calendar years beginning after December 31, 2000.

B. Tax Credit for Renovating Historic Homes (section 1011 of the bill and new section 25B of the Code)

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 qualified rehabilitated building is a nonresidential building 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.

Reasons for Change

The Committee believes that part of the existing housing stock embodies America's history and heritage. Unfortunately, part of this housing stock is in decay and with the decay in the housing stock there is a concomitant deterioration in neighborhoods and communities that were once a vibrant part of the American landscape. The Committee believes that the goals of historic preservation, community revitalization, and home ownership can be pursued concurrently. The Committee believes that a tax incentive can be part of the policy to help large cites and small towns rebuild their core neighborhoods and strengthen their economic, social, and natural environments. Moreover, the Committee believes that a tax incentive will help families relocate to and remain in older communities, capitalize on historic resources, attract reinvestment in older areas, strengthen the tax base of older communities, and, thereby, help to control deterioration and sprawl, and to reinvigorate the life of many communities.

Explanation of Provision

The bill permits 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 is limited to $20,000 ($10,000 in the case of married taxpayer filing a separate return) with respect to any qualified historic home.[105]

The bill applies 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;[106] (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 is 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 applies. In addition, for all structures, at least 5 percent of the rehabilitation expenditures 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.

The credit may be claimed in one of three ways. First, if the taxpayer directly incurs the qualifying expenditures in rehabilitation of his or her principal residence, the taxpayer may claim the tax credit on his or her return.

Second, the taxpayer may claim the credit on his or her return if the taxpayer is the first purchaser of a structure on which qualified rehabilitation expenditures have been made. In this case, the taxpayer must be the first purchaser of the structure after the date the rehabilitation is completed and the purchase must occur within five years after the date the rehabilitation is completed. The structure must, within a reasonable period, become the principal residence of the taxpayer. No credit with respect to the qualified rehabilitation expenditures may have been allowed to the seller of the structure. The Committee intends that the seller furnish the taxpayer

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[105] The Committee intends that a taxpayer may claim the tax credit for qualified rehabilitation expenses with respect to his or her principal residence more than once, but that the total credit claimed with respect to any structure by that taxpayer is limited to $20,000 ($10,000 in the case of married taxpayer filing a separate return).

[106] For this purpose, an historic district will be deemed to have an income greater than or equal to twice the State median income if the median income of any census tract that intersects the area defining the historic district has a median income greater than or equal to twice the State median income.

with such information as the Secretary determines is necessary to determine the amount of allowable credit.

Third, the taxpayer may elect to receive an historic rehabilitation mortgage credit certificate. An historic rehabilitation mortgage credit certificate is a certificate stating the value of the credit that would be allowable to the taxpayer for qualified historic rehabilitation expenditures. The taxpayer may transfer the historic rehabilitation mortgage credit certificate to a lending institution in connection with a loan that is to be secured by the structure on which the qualified rehabilitation expenditures were incurred. In exchange for the rehabilitation mortgage credit certificate, the lending institution provides the taxpayer with a loan, the rate of interest on which is less than that for which the taxpayer otherwise would have qualified. The reduction in interest on the loan must be such that the present value of the difference between interest payments over the term on the loan received by the taxpayer and the interest payments over the term of the loan for which the taxpayer otherwise would have qualified is substantially equivalent to the value stated on the historic rehabilitation mortgage credit certificate. For the purpose of determining the present value of the difference in interest payments, the discount rate shall be determined under principles similar to section 42(b)(2)(C)(ii), except that 65 percent is substituted for 72 percent.

In the case of structures located 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, the taxpayer may elect that the loan be satisfied by principal payments less than those that would otherwise be required such that the present value of the reduced principal payments over the term of the loan be substantially equivalent to the value stated on the historic rehabilitation mortgage credit certificate.[107] The lending institution that enters into the exchange with the taxpayer may claim the credit amount against its regular income tax liability. Reductions in interest payments and reductions in principal payments resulting from a qualified exchange of a rehabilitation mortgage credit certificate would not be taxable income to the taxpayer.

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 is recaptured on a pro rata basis. In the case of a taxpayer who elected to receive and exchange a rehabilitation mortgage credit certificate with a lending institution, any recapture liability would be paid by the taxpayer.

Effective Date

The provision is effective for expenditures paid or incurred beginning after December 31, 1999.

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[107] The taxpayer could elect to receive the benefit of the value of the rehabilitation mortgage credit certificate by a combination of reduced interest payments and reduced principal payments.

C. Provisions Relating to REITs
(secs. 1021-1026, 1031, 1041, 1051, 1061 and 1071 of the bill and secs. 852, 856, and 857 of the Code)

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.[108]

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

[108] 15 U.S.C. 80a-1 and following.

distributions actually made during the taxable year.

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."

Reasons for Change

The Committee believes that a 10-percent value, as well as a 10-percent vote test, is appropriate to test the permitted relationship of a REIT to the entities in which it invests. The Committee is concerned that a REIT may invest in an entity in which it owns virtually all the value (e.g., through preferred stock) while owning a small amount of the vote. The remainder of the voting power might be held by persons related to the REIT such as its officers, directors, or employees. The REIT might effectively be the beneficiary of virtually all the earnings of the entity, through its preferred stock ownership. Also, the REIT might hold significant debt in the entity. If the entity is a corporation, this might significantly reduce the corporate tax that the corporation might pay. If the entity is a partnership engaged in activities that would generate nonqualified income for the REIT if done directly, the REIT might use a significant debt investment in the partnership to reduce the amount of nonqualified income it would report from the partnership while still receiving a significant income stream through the debt.

The Committee believes, however, that certain types of activities that are related to the REIT's real estate investments should be permitted to be performed under the control of the REIT, through the establishment of a "taxable REIT subsidiary". One such type of activity is the provision of certain tenant services that might not be considered customary simply because they are relatively new or "cutting-edge" services that the REIT wishes to have provided in order to retain the competitive value of its properties. The Committee believes it will be simplifying for the REIT to be able to use the taxable REIT subsidiary, so that any uncertainty whether a particular service will be considered "customary" would not affect the REIT's qualification as a REIT. Another type of activity is the performance of real estate management and operation, generally for third parties. A REIT may have developed expertise in such activities with respect to its own properties, and suchexpertise could efficiently be made available to third parties.

The Committee believes it is desirable to obtain information regarding the extent of use of the new taxable REIT subsidiaries and the amount of corporate Federal income tax that such subsidiaries are paying.

The Committee also believes that a number of other simplifying changes are desirable, including allowing limited operation of health care facilities after a lease terminates; simplifying the determination whether an entity is an independent contractor; and modifying and conforming certain RIC and REIT distribution rules.

Explanation of Provision

Taxable REIT subsidiaries

Under the provision, a REIT generally cannot 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 are defined to exclude safe harbor debt owned by a REIT (as defined for purposes of sec. 1361(c)(5)(B)(i) and (ii)) if the obligor on the debt is an individual. Such debt would also generally be excluded if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of a non-individual issuer. In the case of a REIT that owns securities of a partnership, safe harbor debt is 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 applies 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 or a qualified REIT subsidiary under section 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) 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 can 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 can 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 can manage or operate properties, generally for third parties, 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 cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can 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 are treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can 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 cannot 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 is subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary cannot 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 percent is imposed on the portion that was excessive. "Safe harbors" are 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.

<u>Health Care REITS</u>

The provision permits 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 can be granted.

Conformity with regulated investment company rules

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is 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, is modified to clarify that, when the 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 are also 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. In addition, the REIT deficiency dividend rules are modified to apply the same earnings and profits ordering rule to such dividends as other REIT dividends.

Effective Date

The provision is generally effective for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is 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 do 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 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 ceases 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 is treated as a reorganization under section 368(a)(1)(A) of the Code.

D. Increase State Volume Limits on Tax-Exempt Private Activity Bonds (sec. 1081 of the bill and sec. 146 of the Code)

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.

Reasons for Change

The Committee has determined that an adjustment to the annual State private activity bond volume limits to levels comparable to the dollar limits that first applied after enactment of the Tax Reform Act of 1986 is appropriate. Such an adjustment will assist States in meeting infrastructure needs and encouraging economic development and will facilitate continuation of privatization efforts regarding municipal services such as solid waste disposal, water, and sewer services without reversing the general policy of limiting the use of this Federal subsidy for conduit borrowing in transactions that distort market choice and efficiency.

Explanation of Provision

The bill increases 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 is 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 are effective beginning in calendar year 2001 and will be fully effective in calendar year 2005 and thereafter.

E. Treatment of Leasehold Improvements (sec. 1091 of the bill and sec. 168 of the Code)

Present Law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[109] This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.[110] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168(b)(3), (c)(1), (d)(2), and (i)(6)).[111]

Treatment of dispositions of leasehold improvements

A lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or

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

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

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

abandoned by the lessor at the termination of the lease.[112] This rule conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease. For purposes of applying this rule, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. This rule does not apply to the extent section 280B applies to the demolition of a structure, a portion of which may include leasehold improvements.[113]

Reasons for Change

The Committee believes that costs that relate to the leasing of property should not be recovered beyond the term of the lease to the extent the costs do not provide a future benefit beyond that term. Although lease terms differ, the Committee believes that lease terms for commercial real estate typically are shorter than the present-law 39-year recovery period. In the interests of simplicity and administrability, a uniform period for recovery of leasehold improvements is desirable. The Committee bill therefore shortens the recovery period for leasehold improvements to 15 years.

Explanation of Provision

The provision provides that 15-year property for purposes of the depreciation rules of section 168 includes qualified leasehold improvement property. The straight line method is required to be used with respect to qualified leasehold improvement property.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee) of that portion of the building, or by the lessor of that portion of the building. That portion of the building is to be occupied exclusively by the lessee (or any sublessee). The original use of the qualified leasehold improvement property must begin with the lessee, and must begin after December 31, 2000. The improvement must be placed in service more than three years after the date the building was first placed in service.

Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building.

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

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

No special rule is specified for the class life of qualified leasehold improvement property. Therefore, the general rule that the class life for nonresidential real and residential rental property is 40 years applies.

For purposes of the provision, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee, provided the lease is in effect at the time the qualified leasehold improvement property is placed in service. A lease between related persons is not considered a lease for this purpose.

Effective Date

The provision is effective for qualified leasehold improvement property placed in service after December 31, 2002.

TITLE XI. MISCELLANEOUS PROVISIONS

A. Repeal Certain Excise Taxes on Rail Diesel Fuel and Inland Waterway Barge Fuels (sec. 1101 of the bill and secs. 4041 and 4042 of the Code)

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.

Reasons for Change

The Committee notes that in 1993 the Congress enacted the present-law 4.3-cents-per-gallon excise tax as a motor fuels tax on almost all motor fuel uses with the receipts payable to the General Fund. Since that time, the Congress has diverted the 4.3-cents-per-gallon excise tax for most uses to specified trust funds which provide benefits for those motor fuel users who ultimately bear the burden of these taxes. As a result, the Committee finds that generally only rail and barge operators remain as motor fuel users subject to the 4.3-cents-per-gallon excise tax who receive no benefits from a dedicated trust fund as a result of their tax burden. The Committee observes that rail and barge operators compete with other transportation service providers who benefit from expenditures paid from dedicated trust funds. The Committee concluded that it is inequitable and distortive of transportation decisions to continue to impose the 4.3-cents-per-gallon excise tax on diesel fuel used in trains and barges.

Explanation of Provision

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 is repealed. (Upon repeal of the 4.3-cents-per-gallon General Fund tax on diesel fuel used in trains, the Leaking Underground Storage Tank excise tax automatically expires.)

Effective Dates

The provision is effective after September 30, 2000.

B. Tax Treatment of Alaska Native Settlement Trusts (sec. 1102 of the bill and sec. 501 of the Code)

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") [114] 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.

Reasons for Change

The Committee believes that contributions to a Trust by an ANC should not be taxed as distributions to beneficiary-shareholders at the time of the contribution. In addition, the Committee believes that a Trust that is making substantial distributions should be permitted to accumulate a portion of its annual income without tax at the Trust level in order to preserve more funds for the ultimate purposes of the Trust.

In order to eliminate controversy over issues such as whether a particular contribution to or distribution from the Trust would have been a dividend, a return of capital, or capital gain, and to simplify reporting to beneficiaries, the Committee believes that it is appropriate to tax all distributions to beneficiaries at ordinary income rates and to permit simplified reporting of such distributions.

It is not intended that persons other than those presently qualified to be shareholders of an ANC should ever be able to become shareholders of the ANC or to become beneficiaries of the Trust. Should such conditions occur, the benefits provided will cease, and the Trust will be subject to an excise tax.

Explanation of Provision

An Alaska Native Corporation may establish a Trust under section 39 of ANCSA and if

[114] 43 U.S.C. 1601 et. seq.

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

Certain additional restrictions apply. If a beneficial interest 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 is effective for taxable years of Settlement Trusts ending after December 31, 1999, and contributions to such Trusts after that date.

C. Allow Corporations to Take Certain Minimum Tax Credits Against Minimum Tax (sec. 1103 of the bill and sec. 53 of the Code)

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.

Reasons for Change

The Committee believes that corporations with long-term AMT credits should be allowed to use those credits, the value of which has substantially diminished under present law by the passage of time.

Explanation of Provision

The bill allows 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 is 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 bill, an AMT credit is a long-term AMT 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. In determining the amount of its long-term AMT credit, a corporation will be deemed to use its AMT credit in the order of the taxable years in which the adjusted net minimum tax was imposed, whether such usage is (or was) under the present-law regular tax or under the bill. Thus, for example, a calendar year corporation's long-term AMT credit for 2004 will be its adjusted net minimum tax for taxable years after 1986 and before 1999, reduced by the amount of the AMT credit used before 2004.

Effective Date

The provision applies 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 (sec. 1104 of the bill and sec. 172 of the Code)

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.[115] 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.

Reasons for Change

The Committee notes that oil is, and will continue to be, vital to the American economy. Low oil prices have created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to the oil and gas industry. The Committee is concerned that the current economic hardship in the industry could lead to business failures and job losses. Many of these businesses are cash starved. While current operations are unprofitable, many of these businesses have been taxpayers in the past. The Committee finds it appropriate to allow current net operating losses in the oil and gas industry to be carried back to earlier, more profitable, years. This will improve the current cash position of many such businesses and help them weather this current economic storm.

Explanation of Provision

The bill provides a special five-year carryback for certain eligible oil and gas losses. The carryforward period remains 20 years. An "eligible oil and gas loss" is 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 is attributable to an eligible oil and gas loss is treated as a separate NOL and taken into account after the remaining portion of the NOL for the taxable year.

Effective Date

The provision applies to NOLs arising in taxable years beginning after December 31, 1998.

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

E. Election to Expense Geogological and Geophysical Expenditures (sec. 1105 of the bill and sec. 263 of the Code)

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.[116]

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.[117] Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[118] 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[119] (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

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

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

[118] 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.

[119] 1977-1 C.B. 76.

project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after 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.

Reasons for Change

The Committee believes that substantial simplification for taxpayers, significant gains in taxpayer compliance, and reductions in administrative cost can be obtained by allowing all geological and geophysical costs can be deducted currently, regardless of the taxpayer's determination of the suitability of the site or sites examined for future production.

Explanation of Provision

The bill allows geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be deducted currently.

Effective Date

The provision is effective for G&G costs incurred in taxable years beginning after December 31, 1999.

F. Deduction for Delay Rental Payments (sec. 1106 of the bill and sec. 263A of the Code)

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. 263). 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.

Reasons for Change

In essence, a delay rental payment is a substitute, both in the eyes of the payor and the payee, for a royalty payment that would have been made had the property been brought into production. The Committee notes that a royalty payment is deductible currently and, therefore, believes that delay rental payments also should be deductible currently.

Explanation of Provision

The bill allows delay rental payments to be deducted currently.

Effective Date

The provision applies to delay rental payments incurred in taxable years beginning after December 31, 1999.

No inference is intended from the prospective effective date of this provision 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 (sec. 1107 of the bill and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) 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. Among the requirements that must be satisfied in order to qualify for tax-free treatment under 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 (sec. 355(b)(1)). [120] 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 directly 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 (sec. 355(b)(2)(A)).

In determining whether a corporation satisfies the active trade or business requirement, the Internal Revenue Service's position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on 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.[121] 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.[122]

Reasons for Change

The Committee believes that the active trade or business requirement should apply on a limited affiliated group basis. The present law distinction between an operating company and a holding company serves little purpose with respect to corporations that are in the same affiliated group. It is not uncommon for a holding company, in contemplation of a tax-free spin-off, to undergo a series of internal restructurings (e.g., by merging or liquidating subsidiaries or contributing assets downstream) which serve little economic purpose other than to satisfy the

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[120] If immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[121] Rev. Proc. 99-3, sec. 4.01(33), 1999-1 I.R.B. 111

[122] 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.

active trade or business test. The Committee believes that corporations should not be forced to undergo such restructurings simply to satisfy the active trade or business test. Moreover, applying the active trade or business on an affiliated group basis is consistent with the treatment accorded to affiliated groups for other purposes of sec. 355(b)(2).[123] However, the Committee believes that treating the entire affiliated group as a single corporation for this purpose would permit corporations to effectuate a section 355 transaction with respect to stock of a subsidiary that is not engaged in the active conduct of a trade or business. A more appropriate method is to apply the test by focusing on the distributing corporation, the controlled corporation, and those corporations that are in the same ownership chain as the distributing and controlled corporations.

Explanation of Provision

The provision simplifies 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 consists 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 is determined in a similar manner (with the controlled corporation as the common parent).

The following examples illustrate the application of this provision. In each example, assume that P Corp. has owned 100 percent of the stock of X Corp. and Y Corp for more than five years (and X and Y are each engaged in the active conduct of a trade or business). X Corp. also owns 100 percent of the stock of Z Corp. that is not engaged in a trade or business. P is a holding company with no assets other than the stock of X and Y. X, Y and Z are each worth $100.

Example 1: P does a spin-off of Y. The spin-off satisfies the active trade or business requirement. Y, as a stand-alone corporation, satisfies the active trade or business test. Similarly, the P-X-Z separate affiliated group satisfies the test, because 50 percent of the group's assets ($100 of $200) are used in the active conduct of a trade or business.

Example 2: P does a spin-off of X and Z. The spin-off satisfies the active trade or business requirement. The X-Z separate affiliated group satisfies the test, because 50 percent of the group's value ($100 of $200) reflect assets that are used in the active conduct of a trade or business. Similarly, the P-Y separate affiliated group satisfies the test, because 100 percent of the group's assets are used in the active conduct of a trade or business.

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[123] All distributee corporations which are members of the same affiliated group are treated as one distributee corporation for purposes of determining acquisition of control of a corporation under sec. 355(b)(2)(D).

Example 3: X does a spin-off of Z (resulting in X, Y and Z being first-tier subsidiaries of P). The spin-off does not satisfy the active trade or business requirement because X, as a stand-alone corporation, does not satisfy the requirement.

Effective Date

The provision is effective for distributions after the date of enactment. Transition relief is provided for any distribution that is (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission. A corporation can make an irrevocable election to have the transition relief not apply (so that the provision would apply to all distributions after the date of enactment).

H. Increase the Maximum Dollar Amount of Reforestation Expenditures Eligible for Amortization and Credit (sec. 1108 of the bill and secs. 48 and 194 of the Code)

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.[124] 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.[125]

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.[126] 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.

Reforestation amortization is subject to recapture as ordinary income on sale of qualifying

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[124] 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.

[125] Sec. 301(a) of the Multiemployer Pension Plan Amendments Act of 1980.

[126] Treas. Reg. sec. 1.194-3(a).

timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.[127]

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.

Reasons for Change

The Committee believes that it is appropriate to increase the amount eligible for amortization and the credit to reflect the increased costs of reforestation. In light of the current financial difficulties in the timber industry, the Committee also believes that it is appropriate to temporarily allow amortization of reforestation expenditures without limit.

Explanation of Provision

The provision increases 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, the provision removes the limitation on the amount eligible for 7-year amortization.

Effective Date

The provision is effective for expenditures paid or incurred in taxable years beginning after December 31, 1999. For taxable years beginning in 2000 through 2003, the amount of reforestation expenditures eligible for the credit is limited to $25,000 and no limit applies to the amount eligible for 7-year amortization. For taxable years beginning after 2003, the amount of reforestation expenditures eligible for 7-year amortization and for the credit is limited to $25,000.

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[127] Sec. 1245(b)(7); Treas. Reg. sec. 1.194-1(c).

I. Modify Excise Tax on Arrow Components and Accessories (sec. 1109 of the bill and sec. 4161 of the Code)

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.

Reasons for Change

The Committee believes that modifications must be made to the present-law tax on arrows and points to better reflect current design and practice in the manufacture of arrows and points.

Explanation of Provision

The bill makes two modifications to the excise tax on arrows and arrow accessories. First, the amendment extends the 12.4-percent tax on arrow components to inserts and outserts designed for use with taxable arrows. Inserts and outserts are defined as articles used to attach a point to an arrow shaft. Second, the amendment reclassifies "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 provision applies to sales by manufacturers beginning on the first day of the first calendar quarter that begins more than 30 days after the bill's enactment.

J. Increase Joint Committee on Taxation Refund Review Threshold to $2 Million (sec. 1110 of the bill and sec. 6405 of the Code)

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.

Reasons for Change

The Committee believes that it is appropriate to increase the refund review threshold, which has been set at $1,000,000 since 1990. Increasing it will accelerate the issuance of refunds between $1,000,000 and $2,000,000 to the taxpayers involved. In addition, this increase will free up significant resources of both the Internal Revenue Service and the staff of the Joint Committee on Taxation, without materially impairing the ability to monitor problems in the administration of the tax laws.

Explanation of Provision

The provision increases 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 provision is effective on the date of enactment, except that the higher threshold does not apply to a refund or credit with respect to which a report was made before the date of enactment.

K. Modify the Definition of Rural Airport Eligible for Reduced Air Passenger Ticket Tax Rate (sec. 1111 of the bill and sec. 4261 of the Code)

Present Law

Air passenger transportation is subject to an excise tax equal to 8 percent of the amount paid plus $2 per flight segment. After September 30, 1999, the *ad valorem* portion of this tax will decrease to 7.5 percent and the flight segment portion will increase to $2.25. Additional increases in the flight segment tax are scheduled until that rate equals $3 per flight segment (with indexing of the $3 amount one year after it is reached).

Flight segments to or from qualified rural airports are eligible for a reduced air passenger tax of 7.5 percent, with no segment tax being imposed on those segments. A qualified rural airport is defined as an airport that enplaned fewer than 100,000 passengers in the second preceding calendar year and either (1) is not located within 75 miles of a larger airport not qualified for the reduced tax rate or (2) was receiving essential air service subsidy payments as of August 5, 1997.

Reasons for Change

The Committee notes that the present-law definition of "rural airports" generally encompasses those airports that do not offer potential customers a viable alternative to a larger airport from which a ticket would subject the purchaser to the flight segment tax in addition to the *ad valorem* tax. The Committee observes that airports located on islands with no direct access by road from the mainland also would not offer potential customers a viable alternative to a larger airport, even if the island airport is within 75 miles of the larger airport.

Explanation of Provision

The definition of qualified rural airport is expanded to include otherwise qualified airports that are located within 75 miles of a larger airport not qualified for the reduced tax rate if those airports are not connected by road to the larger airport (e.g., an airport on an island not connected by bridge to the mainland).

Effective Date

The provision is effective for amounts paid after December 31, 1999, for air transportation beginning after that date.

L. Dividends Paid by Cooperatives (sec. 1112 of the bill and sec. 1388(a) of the Code)

Present Law

In general

Cooperatives, including tax-exempt farmers' cooperatives, and their members are subject to special tax rules under subchapter T of the Code (sec. 1381 et seq.). In general, these provisions operate to treat the cooperative more like a conduit than a separate taxable business enterprise. In general, subchapter T applies to tax-exempt farmers' cooperatives (described in sec. 521(b)) or any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception -- the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. Except for tax-exempt farmers' cooperatives, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. The availability of these deductions for the cooperative has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with members.

Definition of patronage dividends

Treasury regulations provide that the term patronage dividends are amounts paid to patrons (1) on the basis of the quantity or value of business done with or for its patrons, (2) under a valid enforceable written obligation to the patron to pay such amount, which obligation existed before the cooperative received such amounts, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons. Treas. Reg. sec. 1.1388-1(a).

Treatment of dividends paid by cooperative (the "dividend allocation rule")

Those Treasury Regulations also provide that "net earnings .... shall be reduced by dividends paid on capital stock or other proprietary capital interests." Treas. Reg. sec. 1.1388-1(a). The effect of this rule is to reduce the amount of earnings that the cooperative can treat as patronage earnings which, consequently, reduces the amount that cooperative can deduct as patronage dividends. The dividend allocation rule of the Treasury Regulations initially was applied by the courts where the organizational documents of the cooperative provided that the dividends could be paid from both patronage and nonpatronage earnings, but later was applied in all cases.[128]

Reasons for Change

The Committee believes that the dividend allocation rule should not apply to the extent that the cooperative's organizational documents provide that capital stock dividends do not reduce the amounts owed to patrons as patronage dividends. To the extent that capital stock dividends are in addition to amounts paid under the cooperative's organizational documents to patrons as patronage dividends, the Committee believes that those capital stock dividends are not being paid from earnings from nonpatronage business.

In addition, the Committee believes cooperatives should be able to raise needed equity capital by issuance of capital stock without dividends paid on that capital stock causing taxation of the cooperative on a portion of its patronage income.

Explanation of Provision

Under the provision, patronage-sourced income is not reduced to the extent that the organizational documents (articles of incorporation, bylaws, or contract with patrons) provide that dividends on capital stock (or other proprietary capital interests) are "in addition" to amounts otherwise payable as patronage dividends.

Effective Date

The provision is effective for distributions made in taxable years beginning after the date of enactment.

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[128] The rule was first adopted by in cases where dividends paid by a cooperative came from earnings from both patronage and nonpatronage business (see A.R.R. 6697, C.B. III-1, 287 (payment of dividends from reserve funded from a portion of all earnings); Mississippi Chemical Corp. v. U.S., 197 F. Supp. 490 (S.D. Miss., 1961)("common stock dividends are to be paid first from profits on non-stockholder business and only the deficiency, if any, may be deducted from margins on stockholder patronage"), aff'd, 326 F.2d 569 (5th Cir. 1964)), but the dividend allocation rule also was extended by courts, and eventually through regulations and rulings issued by the Internal Revenue Service, to apply also to cases where dividends on capital stock could be paid only from earnings from nonpatronage business (Valparaiso Grain & Lumber Company v. Commissioner, 44 B.T.A. 125 (1941)("bylaws provide for payment of fixed dividends on capital stock before any distributions of patronage rebates can be made"); Rev. Rul. 68-228, 68-2 C.B. 385).

M. Permit Consolidation of Life and Nonlife Insurance Companies (sec. 1113 of the bill and secs. 1504(b)(2) and 1504(c) of the Code)

Present Law

Under present law, an affiliated group of corporations means one or more chains of includible corporations connected through stock ownership with a common parent corporation (sec. 1504(a)(1)). The stock ownership requirement consists of an 80-percent voting and value test. In general, an affiliated group of corporations may file a consolidated tax return for Federal income tax purposes.

Life insurance companies (subject to tax under section 801) generally are not treated as includible corporations, and therefore may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations (sec. 1504(c)(2)).

Under the election to treat life insurance companies as includible corporations of an affiliated group, two special 5-year limitation rules apply. The first 5-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The second 5-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first 5 years the life and nonlife-insurance corporations have been members of the same affiliated group (sec. 1503(c)(2)). This rule applies to nonlife losses for the current taxable year or as a carryover or carryback.

A separate 35-percent limitation also applies under the election to treat life insurance companies as includible corporations of an affiliated group (sec. 1503(c)(1)). This rule provides that if the non-life-insurance members of the group have a net operating loss, then the amount of the loss that is not absorbed by carrybacks against the nonlife-insurance members' income may offset the life insurance members' income only to the extent of the lesser of: (1) 35 percent of the amount of the loss; or (2) 35 percent of the life insurance members' taxable income. The unused portion of the loss is available as a carryover and is added to subsequent-year losses, subject to the same 35-percent limitation.

Reasons for Change

The Committee understands that the five-year limitation rule under the election to treat life insurance companies as includible corporations gives rise to considerable complexity in application. The Committee believes that desirable simplification of the tax law can be achieved by repeal of the five-year limitation on consolidation.

Explanation of Provision

The provision repeals the 5-year limitation rule relating to consolidation under the election to treat life insurance companies as includible corporations of an affiliated group. The provision also repeals the rule that a life insurance corporation is not an includible corporation unless the common parent makes an election to treat life insurance companies as includible corporations. Thus, under the provision, a life insurance company is treated as an includible corporation starting with the first taxable year for which it becomes a member of the affiliated group and otherwise meets the definition of an includible corporation. However, as under present law, any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first five years the life and nonlife-insurance corporations have been members of the same affiliated group. The provision retains the 35-percent limitation of present law with respect to any life insurance company that is an includible corporation of an affiliated group.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

To the extent that a consolidated net operating loss is created or increased by the provision, the loss may not be carried back to a taxable year beginning before January 1, 2001. In addition, no affiliated group terminates solely by reason of the provision. The provision waives the 5-year waiting period for reconsolidation under section 1504(a)(3), in the case of any corporation that was previously an includible corporation, but was subsequently deemed not to be an includible corporation as a result of becoming a subsidiary of a corporation that was not an includible corporation by reason of the 5-year rule of section 1504(c)(2) (providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed).

N. Modify Personal Holding Company "Lending or Finance Business" Exception (sec. 1114 of the bill and sec. 542 of the Code)

Present Law

Personal holding companies (PHC's) are subject to a 39.6% tax on undistributed PHC income. This tax can be avoided by distributing the income to shareholders, who then pay shareholder level tax. PHC's are closely held companies with at least 60% "personal holding company income" (PHCI). This is generally passive income, including interest, dividends, and rents. Certain rent is excluded from the definition, if rent is at least 50 percent of the adjusted ordinary gross income of the company and other undistributed PHCI does not exceed 10 percent of the adjusted ordinary gross income.

In the case of a group of corporations filing a consolidated return, with certain exceptions, the application of the PHC tax to the group and any member thereof is generally determined on the basis of consolidated income and consolidated PHCI. If any member of the group is excluded from the definition of a PHC under certain provisions (including one for certain lending or finance businesses), then each other member of the group is tested separately for PHC status.

A special rule of present law excludes a lending or finance business from the definition of a PHC if certain requirements are met. At least 60% of its income must come from the active conduct of a lending or finance business, and no more than 20% of its adjusted gross income may be from certain other PHCI. A lending or finance business does not include a business of making loans longer than 144 months (12 years). Also, the deductions attributable to this active lending or finance business (but not including interest expense) must be at least 5 percent of income over $500,000 (plus 15 percent of income under that amount).

Reasons for Change

The Committee believes that present law does not adequately account for the fact that lending and leasing can be similar financing activities, and that these activities can be active businesses even though they may not meet all the present law requirements for exclusion from PHC status.

The Committee is also concerned that in the context of an affiliated group filing a consolidated return, the present-law rule requiring 60 percent of the income of such a company to be from a lending or finance business can prevent qualification of a member of the group merely because other members of the group receive substantial income from other active businesses (if such other income exceeds 40 percent of the group's total income).

Explanation of Provision

The provision modifies the personal holding company exclusion for lending or finance companies to provide that, in determining whether a member of an affiliated group (as defined in section 1504(a)(1)) filing a consolidated return is a lending or finance company, only corporations engaged in a lending or finance business are taken into account, and all such companies are aggregated for purposes of this determination. The effect of this rule is to treat a corporation as a lending or finance company if all companies engaged in a lending or finance business in the affiliated group, in the aggregate, satisfy the requirements of the exclusion.

The provision also repeals the business expense requirement and the limitation on the maturity of loans made by a lending or finance business.

The provision also broadens the definition of a lending or finance business to include providing financial or investment advisory services, as well as engaging in leasing, including entering into leases and/or purchasing. servicing, and/or disposing of leases and leased assets.

Rents that are not derived from the active and regular conduct of a lending or finance business would continue to be treated under the present law personal holding company income rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

O. Tax Credit for Modifications to Inter-City Buses Required Under the Americans with Disabilities Act of 1990 (sec. 1115 of the bill and sec. 44 of the Code

Present Law

Present law provides a tax credit ("the disabled access credit") for eligible access expenditures paid or incurred by an eligible small business so that such business may comply with the Americans with Disabilities Act of 1990, (the"ADA"). The amount of the credit for any taxable year is equal to 50 percent of the eligible access expenditures for the taxable year that exceed $250 but do not exceed $10,250. Therefore the maximum annual credit is $5,000. An eligible small business is defined for any taxable year as a person that had gross receipts for the preceding taxable year that did not exceed $1 million or had no more than 30 full-time employees during the preceding taxable year.

Eligible access expenditures are defined as amounts paid or incurred by an eligible small business for the purpose of enabling such eligible small business to comply with applicable requirements of the ADA, as in effect on the date of enactment of the credit. Eligible access expenditures generally include amounts paid or incurred (1) for the purpose of removing architectural, communication, physical, or transportation barriers which prevent a business from being accessible to, or usable by, individuals with disabilities; (2) to provide qualified interpreters or other effective methods of making aurally delivered materials available to individuals with hearing impairments; (3) to provide qualified readers, taped texts, hearing impairments; (3) to provide qualified readers, taped texts and other effective methods of making visually delivered materials available to individuals with visual impairments; (4) to acquire or modify equipment or devices for individuals with disabilities; or (5) to provide other similar services, modifications, materials, or equipment. The expenditures must be reasonable and necessary to accomplish these purposes.

The disabled access credit is a general business credit and is subject to the present-law limitations on the amount of the general business credit that may be used for any taxable year. However, the portion of the unused business credit for any taxable year that is attributable to the disabled access credit may not to be carried back to any taxable year ending before the date of enactment of the credit.

Reasons for Change

The Committee believes that the costs of compliance with the ADA creates too heavy a burden on taxpayers in the case of certain inter-city buses. Therefore the Committee believes that the disabled access credit should be expanded to mitigate the burden of these taxpayers.

Explanation of Provision

The bill extends the disabled access credit to a business without regard to the eligible small business limitation generally applicable under the credit for the cost of making certain inter-city buses comply with the ADA under the Department of Transportation's ("DOT's") final rule making on September 28, 1998, (49 CFR Part 37). Specifically, the definition of eligible access expenditure under the credit is expanded to include the incremental capital cost paid or incurred by the taxpayer so that certain inter-city buses satisfy the DOT's rule making under the ADA. For purposes of this provision, the allowable credit is 50 percent of the eligible access expenditures, per bus, for the taxable year that exceed $250 but do not exceed $30,250. Therefore the maximum credit is $15,000, per bus. The otherwise allowable eligible access expenditures are reduced by any Federal or State grant monies received by the taxpayer to subsidize such expenditures relating to such intercity buses. For these purposes, inter-city buses are buses eligible for the reduced diesel fuel tax rate of 7.4 cents per gallon.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999 and before January 1, 2012.

P. Increased Deduction for Business Meals While Operating Under Department of Transportation Hours of Service Limitations (sec. 1116 of the bill and sec. 274 of the Code)

Present Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for food and beverage is limited to 50 percent of the otherwise deductible amount. Exceptions to the 50 percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs.

The 1997 Act increased to 80 percent the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation.

Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,

(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,

(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and

(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule.

Taxable years beginning in	Deductible percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

Reasons for Change

Individuals subject to the hours of service limitations of the Department of Transportation are frequently forced to eat meals away from home in circumstances where their choice is limited. The Committee believes that it is appropriate to accelerate by one year the full 80 percent deduction for the cost of food and beverages consumed while away from home on business by these individuals.

Explanation of Provision

The bill accelerates the full 80 percent deduction to taxable years beginning after 2006.

Effective Date

The provision is effective for taxable years beginning after 2006.

Q. Authorize Limited Private Activity Tax-Exempt Financing for Highway Construction (sec. 1117 of the bill)

Present Law

Present law exempts interest on State or local government bonds from the regular income tax if the proceeds of the bonds are used to finance governmental activities of those units and the bonds are repaid with governmental revenues. Interest on bonds issued by States or local governments acting as conduits to provide financing for private persons is taxable unless a specific exception is provided in the Code. No such exception is provided for bonds issued to provide conduit financing for privately constructed and/or privately operated highways (e.g. toll roads).

Reasons for Change

The Committee believes it is important to provide increased flexibility for tax-exempt financing of a limited number of public-private partnerships in the construction and operation of transportation infrastructure as provided under the Transportation Equity Act for the 21st Century.

Explanation of Provision

The bill authorizes issuance of up to $15 billion of private activity tax-exempt bonds to finance the construction of up the 15 private highway pilot projects made eligible for other special assistance under the Transportation Equity Act for the 21st Century. Bonds for these projects generally will be subject to all Code provisions governing issuance of tax-exempt private activity bonds except (1) the annual State volume limits (sec. 146) and (2) no proceeds of these bonds may be used to finance land.

Effective Date

The provision applies to bonds issued after December 31, 1999.

R. Extend Tax Credit for First-Time D.C. Homebuyers (sec. 1118 of the bill and sec. 1400C of the Code)

Present Law

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2000.

Reasons for Change

The D.C. first-time homebuyer credit is designed to encourage eligible homebuyers to buy in the District of Columbia so as to stabilize or increase its population and improve its tax base. Recently, the District of Columbia has been experiencing an increase in home sales. Although it is difficult to know to what extent the D.C. homebuyer credit may have been a factor in the increase, the Committee believes that the enactment of the first-time homebuyer credit in 1997 has contributed to the increase and should be extended.

The Committee is concerned that the present-law phase-out range for joint filers is disadvantageous to married couples filing a joint return because the phase-out range for joint filers is less than twice that for individuals. The Committee believes that this disparity should be eliminated.

Explanation of Provision

The D.C. first-time homebuyer tax credit is extended for 1 year, through December 31, 2001. In addition, the phase-out range for married individuals filing a joint return is increased so that it is twice that of individuals. Thus, under the provision, the credit phases out for joint filers with adjusted gross income between $140,000 and $180,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 1999.

S. Expand the Zero-percent Capital Gains Rate for DC Zone Assets (sec. 1119 of the bill and sec. 1400B of the Code)

Present Law

Present law provides a zero-percent capital gains rate for capital gains from the sale of certain qualified DC Zone assets held for more than five years . In general, a "DC Zone asset" means stock or partnership interests held in, or tangible assets held by, a DC Zone business. A DC Zone business generally refers to certain enterprise zone businesses within the DC Zone.[129] For purposes of the zero-percent capital gains rate, the D.C. Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent as determined on the basis of the 1990 Census (sec. 1400B(d)).

Reasons for Change

The Committee believes that the zero-percent capital gains rate is an effective incentive to encourage economic development in the District of Columbia. Limiting the benefits of the zero percent rate to particular census tracts hampers the effectiveness of the benefit and creates disparities in the tax treatment of similar investments located in adjacent census tracts. The Committee believes that economic development should be encouraged throughout the District.

Explanation of Provision

The provision eliminates the 10-percent poverty rate limitation for purposes of the zero-percent capital gains rate. Thus, the zero-percent capital gains rate applies to capital gains from the sale of assets held more than five years attributable to certain qualifying businesses located in the District of Columbia.

Effective Date

The provision is effective for DC Zone business stock and partnership interests originally issued after, and DC Zone business property assets originally acquired by the taxpayer after, December 31, 1999.

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[129] For purposes of the zero-percent capital gains rate, a DC Zone business is defined by reference to the definition of an enterprise zone business in section 1397B, except that (1) the requirement that 35 percent of the employees of the business must be residents of the DC Zone does not apply, and (2) the DC zone business must derive at least 80 percent (as opposed to 50 percent) of its total gross income from the active conduct of a qualified business within the DC Zone (sec. 1400B(c)).

T. Establish a Seven-year Recovery Period for Natural Gas Gathering Lines (sec. 1120 of the bill and sec. 168 of the Code)

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are set forth in Revenue Procedure 87-56.[130]

Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. The uncertainty regarding the appropriate recovery period has resulted in litigation between taxpayers and the IRS. Recently, the 10th Circuit Court of Appeals held that natural gas gathering lines owned by nonproducers fall within the scope of Asset class 13.2 (i.e., seven-year recovery period).[131]

Reasons for Change

The Committee believes that the appropriate recovery period for natural gas gathering lines is seven years. This is consistent with the historical treatment of such property.

Explanation of Provision

The provision establishes a statutory seven-year recovery period for all natural gas gathering lines. For this purpose, a natural gas gathering line is defined to include pipe, equipment, and appurtenances that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

Effective Date

The provision is effective for property placed in service on or after the date of enactment.

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[130] 1987-2 C.B. 674.

[131] Duke Energy v. Commissioner, 172 F.3d 1255 (10th Cir. 1999), rev'g 109 T.C. 416 (1997). See also True v. United States, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997) (same).

No inference is intended as to the proper treatment of such property placed in service before the date of enactment.

U. Reclassify Air Transportation on Certain Small Seaplanes As Non-Commercial Aviation for Excise Tax Purposes (sec. 1121 of the amendment and sec. 4261 of the Code)

Present Law

Commercial air passenger transportation is subject to an excise tax equal to 8 percent of the amount paid plus $2 per flight segment. After September 30, 1999, the *ad valorem* portion of this tax will decrease to 7.5 percent and the flight segment portion will increase to $2.25. Additional increases in the flight segment tax are scheduled until that rate equals $3 per flight segment (with indexing of the $3 amount one year after it is reached). In addition, fuel used in commercial aviation is subject to a 4.3-cents-per-gallon excise tax on fuels used in the aircraft.

In lieu of the ticket taxes imposed on commercial air passenger transportation, non-commercial transportation is subject to excise taxes on the fuels used in the aircraft. Non-commercial air transportation is defined as transportation which is not for hire. The fuels excise tax rates are 19.3 cents per gallon (aviation gasoline) and 21.8 cents per gallon (jet fuel).

Revenues from all of these excise taxes are deposited in the Airport and Airway Trust Fund to finance Federal Aviation Administration programs.

Reasons for Change

The Committee observes that seaplanes do not make as full utilization of FAA services as do planes that offer passenger service out of traditional airports. The Committee, therefore, believes it is appropriate to exempt such service from the air passenger excise taxes and instead impose only the fuels excise taxes.

Explanation of Provision

The provision re-classifies passenger transportation for hire on certain small seaplanes as non-commercial aviation. As such, the transportation will be subject to the full 19.3 cents-per-gallon and 21.8-cents-per-gallon excise taxes rather than the passenger ticket tax. Transportation is eligible for this provision only it occurs on seaplanes (planes that both take off from and land on water) and that have a maximum certificated takeoff weight of 6,000 pounds or less with respect to any flight segment.

Effective Date

The provision is effective for transportation beginning after December 31, 1999.

TITLE XII. EXTENSION OF EXPIRING PROVISIONS

A. Extension of Research and Experimentation Credit and Increase in the Rates for the Alternative Incremental Research Credit (sec. 1201 of the bill and sec. 41 of the Code)

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally 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.[132]

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[132] 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

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").[133]

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

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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)).

[133] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the 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.

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 involve a process of experimentation related to functional aspects, performance, reliability, or quality of a business component.

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)).

Reasons for Change

The Committee believes that increasing technological knowledge ultimately will lead to new and better products produced at lower costs. New and better products and lower production costs are the genesis of economic growth. In addition, the Committee believes that the repeated scenario of temporary lapses followed by reinstatement of the credit create uncertainty for taxpayers, uncertainty that inhibits investment in research initiatives. For this reason, the Committee believes it is important to extend permanently the research and experimentation tax credit.

In addition, the Committee believes the alternative incremental credit enacted in 1996 should be strengthened. The alternative incremental research credit was enacted to respond to the changing economic circumstances of many taxpayers which invest heavily in research. However, the Committee believes that under current law, the alternative incremental research credit provides less of a research incentive than does the regular research and experimentation tax credit. Therefore, the Committee believes it is appropriate to increase the rate of the alternative incremental research credit.

Explanation of Provision

The bill permanently extends the research tax credit.

In addition, the bill increases the credit rate applicable under the alternative incremental research credit 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

The extension of the research credit is effective for qualified research expenditures paid or incurred after June 30, 1999. The increase in the credit rate under the alternative incremental research credit is effective for taxable years beginning after June 30, 1999.

B. Extend Exceptions under Subpart F for Active Financing Income (sec. 1202 of the bill and secs. 953 and 954 of the Code)

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.[134]

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,

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[134] 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.

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, 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.

Reasons for Change

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from foreign personal holding company income were enacted[135] for income from the active conduct of an insurance, banking, financing, or similar business. In the Tax and Trade Relief Extension Act of 1998 (the "1998 Act"),[136] the Congress extended the temporary exceptions for an additional year, with certain modifications designed to treat various types of businesses with active financing income more similarly to each other than did the 1997 provision. The Committee believes that it is appropriate to extend the temporary exceptions, as modified in the 1998 Act, for five years.

Explanation of Provision

The bill extends 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.

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[135] The President canceled this provision in 1997 pursuant to the Line Item Veto Act. On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. Clinton v. City of New York, 118 S. Ct. 2091 (June 25, 1998).

[136] Division J of H.R. 4328, the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999.

Effective Date

The provision is 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 Net Income Limitation on Percentage Depletion from Marginal Oil and Gas Wells (sec. 1203 of the bill and sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain taxpayers, the deductions may be determined using the percentage depletion method. The percentage depletion deduction is calculated as a percentage of the gross income from producing any property. 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.

Reasons for Change

The Committee notes that oil is, and will continue to be, vital to the American economy. The Committee observes that low oil prices have created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to the oil an gas industry. The current economic hardship in the industry could lead to business failures and job losses. The Committee finds it appropriate to extend the present-law rule suspending the 100-percent -of-net-income limitation with respect to oil and gas production from marginal wells. The Committee believes that by reducing current taxable income, less cash will have to be devoted to income tax payments, and the current cash position of many such businesses will improve, helping them weather this current economic storm.

Explanation of Provision

The bill extends 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 provision is effective for taxable years beginning after December 31, 1999.

D. Extend the Work Opportunity Tax Credit (sec. 1204 of the bill and sec. 51 of the Code)

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.

Reasons for Change

The Committee believes the preliminary experience of the WOTC is promising as an incentive for employers to hire individuals who are under-skilled, undereducated, or who generally may be less desirable (e.g., lacking in work experience) to employers. A temporary extension of this credit will allow the Congress and the Treasury and Labor Departments to continue to monitor the effectiveness of the credit.

Explanation of Provision

The bill extends the WOTC for 5 years (through July 1, 2004).

Effective Date

Generally, the provision is 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 (sec. 1204 of the bill and sec. 51A of the Code)

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.

Reasons for Change

The Committee believes that the credit should be temporarily extended to provide the Congress and the Treasury and Labor Departments a better opportunity to assess the operation and effectiveness of the credit in meeting its goals. When enacted in the Taxpayer Relief Act of 1997, the goals of the welfare-to-work credit were: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment; and (3) to encourage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment.

Explanation of Provision

The bill extends the welfare-to-work credit for five years, so that the credit is available for eligible individuals who begin work for an employer before July 1, 2004.

Effective Date

The provision is 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 (sec. 1205 of the bill and sec. 45 of the Code)

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 three taxable years and carried forward 15 taxable years (sec. 39).

Reasons for Change

The Committee believes that the credit provided under section 45 has been important to the development of environmentally friendly, renewable wind power and that extending the placed in service date will increase the further development of wind resources.

The Committee observes, however, that there is organic waste that is disposed of in an uncontrolled manner or burned in the open. Such organic waste can be a fuel source which, if utilized, can promote a cleaner environment. The Committee further observes that landfills produce methane as entombed garbage decays. Methane can be a valuable fuel but, if permitted to dissipate into the atmosphere, it may create environmental damage. The Committee believes that providing a credit to utilize these organic fuel sources can help produce needed electricity while providing environmental benefits for communities and the nation.

Explanation of Provision

The present-law tax credit for electricity produced by wind and closed-loop biomass is extended for five years, for facilities placed in service after June 30, 1999, and before July 1, 2004. The provision also modifies the tax credit to include electricity produced from poultry litter, for facilities placed in service after December 31, 1999, and before July 1, 2004. The credit for electricity produced from poultry litter is available to the lessor/operator of a qualified facility that is owned by a governmental entity. Poultry litter is to include the wood shavings, straw, rice hulls, and other bedding material for the disposition of poultry manure from birds raised for sale. The credit further is expanded to include electricity produced from landfill gas by the owner of the gas collection facility, for electricity produced from facilities placed in service after December 31, 1999 and before June 30, 2004.

Finally, the credit is expanded to include electricity produced from certain other biomass (in addition to closed-loop biomass and poultry waste). This additional biomass is defined as solid, nonhazardous, cellulose waste material which is segregated from other waste materials and which is derived from forest resources, but not including old-growth timber. The term also includes urban sources such as waste pallets, crates, manufacturing and construction wood waste, and tree trimmings, or agricultural sources (including grain, orchard tree crops, vineyard legumes, sugar, and other crop by-products or residues. The term does not include unsegregated municipal solid waste or paper that commonly is recycled. In the case of this additional biomass, the credit applies to electricity produced after December 31, 1999 from facilities that are placed in service before January 1, 2003 (including facilities placed in service before the date of enactment of this provision). The credit is allowed for production attributable to biomass produced at facilities that are co-fired with coal.

Effective Date

The extension of the tax credit for electricity produced from wind and closed-loop biomass is effective for facilities placed in service after June 30, 1999. The modification to include electricity produced from poultry litter and landfill gas is effective for facilities placed in service after December 31, 1999. The modification to include other types of biomass is effective for facilities placed in service before January 1, 2003, but no credits may be claimed for production before January 1, 2000.

G. Extend Exemption From Diesel Dyeing Requirement for Certain Areas in Alaska (sec. 1206 of the bill and sec. 4082 of the Code)

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.

Reasons for Change

Unlike most other States, Alaska's vast undeveloped expanse results in substantial amounts of motor fuels being used "off road." Such use of fuels are exempt from tax and generally is required to be dyed. Dyed fuel requires separate holding tanks. However, with the large proportion of exempt use that occurs in Alaska and with a dispersed population, the Committee believes that maintaining the fuel dyeing regime in Alaska imposes too large a burden on too many fuel distributors and an inordinate administrative burden on the Internal Revenue Service in comparison to the general benefits of the fuel dyeing regime.

Explanation of Provision

The bill makes the excise tax exemption for Alaska urban areas permanent (i.e., independent of the EPA rules).

Effective Date

The provision is effective on the date of enactment.

H. Expensing of Environmental Remediation Expenditures and Expansion of Qualifying Sites (sec. 1207 of the bill and sec. 198 of the Code)

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 before January 1, 2001.

Reasons for Change

The Committee would like to see more so-called “brownfield” sites brought back into productive use in the economy. Cleaning up such sites mitigates potential harms to public health and can help revitalize affected communities. The Committee seeks to encourage the clean up of contaminated sites. To achieve this goal, the Committee believes it is necessary to make two modifications to present law. First, it is necessary to expand the set of brownfield sites that may claim the tax benefits of expensing beyond the relatively narrow class of sites identified in the Taxpayer Relief Act of 1997. Second, it is necessary to permit taxpayers more time to avail themselves of the tax benefits of expensing.

Explanation of Provision

The bill extends the expiration date for eligible expenditures to include those paid or incurred before July 1, 2004.

In addition, the bill eliminates 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, but not those sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

Effective Date

The provision to extend the expiration date is effective upon the date of enactment. The provision to expand the class of eligible sites is effective for expenditures paid or incurred after December 31, 1999.

TITLE XIII. REVENUE OFFSET PROVISIONS

A. Modify Foreign Tax Credit Carryover Rules (sec. 1301 of the bill and sec. 904 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate 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.

Reasons for Change

The Committee believes that reducing the carryback period for foreign tax credits to one year and increasing the carryforward period to seven years will reduce some of the complexity associated with carrybacks while continuing to address the timing differences between U.S. and foreign tax rules.

Explanation of Provision

The bill reduces the carryback period for excess foreign tax credits from two years to one year. The bill also extends the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The provision applies to foreign tax credits arising in taxable years beginning after December 31, 1999.

B. Expand Reporting of Cancellation of Indebtedness Income (sec. 1302 of the bill and sec. 6050P of the Code)

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 Internal Revenue Service (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 Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (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)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, 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.

Reasons for Change

The Committee believes that it is appropriate to treat discharges of indebtedness that are made by similar entities in a similar manner. Accordingly, the Committee believes that it is appropriate to extend the scope of this information reporting provision to include indebtedness discharged 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).

Explanation of Provision

The bill requires information reporting on indebtedness discharged 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 provision is effective with respect to discharges of indebtedness after December 31, 1999.

C. Increase Elective Withholding Rate for Nonperiodic Distributions from Deferred Compensation Plans (sec. 1303 of the bill and sec. 3405 of the Code)

Present Law

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,[137] (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 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.

Reasons for Change

[137] All IRA distributions are treated as if includible in income for purposes of this rule. A technical correction contained in the bill modifies this rule in the case of Roth IRAs.

The present-law 10-percent withholding rate is lower than the lowest income tax rate. Increasing the withholding rate to the lowest income tax rate makes it more likely that individuals who want withholding will have the correct amount of tax withheld.

Explanation of Provision

Under the bill, the withholding rate for nonperiodic distributions would be increased from 10 percent to 15 percent. As under present law, unless the distribution is an eligible rollover distribution, the payee could elect not to have withholding apply. The bill does not modify the 20-percent withholding rate that applies to any distribution that is an eligible rollover distribution.

Effective Date

The provision is effective for distributions made after December 31, 2000.

D. Extension of IRS User Fees
(sec. 1304 of the bill and new sec. 7527 of the Code)

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[138] extended the statutory authorization for these user fees[139] through September 30, 2003.

Reasons for Change

The Committee believes that it is appropriate to extend the statutory authorization for these user fees for an additional six years.

Explanation of Provision

The bill extends the statutory authorization for these user fees through September 30, 2009. The bill also moves the statutory authorization for these fees into the Internal Revenue Code.

Effective Date

The provision, including moving the statutory authorization for these fees into the Code and repealing the off-Code statutory authorization for these fees, is effective for requests made after the date of enactment.

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[138] 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).

[139] 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 (sec. 1305 of the bill, sec. 420 of the Code, and secs. 101, 403, and 408 of ERISA)

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.[140]

Reasons for Change

The Committee believes that it is appropriate to provide a temporary extension of the present-law rule permitting an employer to make a qualified transfer of excess pension assets to a section 401(h) account for retiree health benefits as long as the security of employees' pension benefits is not threatened by the transfer. In light of the increasing cost of retiree health benefits, the Committee also believes that it is appropriate to replace the minimum benefit requirement applicable to qualified transfers under present law with a minimum cost requirement.

Explanation of Provision

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 is extended through September 30, 2009. In addition, the present-law minimum benefit requirement is 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 is 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 is the higher of the applicable employer costs for each of the 2 taxable years immediately preceding

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[140] Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), provides that plan participants, the Secretaries of Treasury and the Department of Labor, the plan administrator, and each employee organization representing plan participants must be notified 60 days before a qualified transfer of excess assets to a retiree health benefits account occurs (ERISA sec. 103(e)). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA (ERISA sec. 408(b)(13)) or a prohibited reversion of assets to the employer (ERISA sec. 403(c)(1)). For purposes of these provisions, a qualified transfer is generally defined as a transfer pursuant to section 420 of the Internal Revenue Code, as in effect on January 1, 1995.

the taxable year of the transfer. The applicable employer cost for a taxable year is 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 provision is 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 modification of the minimum benefit requirement is effective with respect to transfers after the date of enactment. An employer is 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 is permitted to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and is required to satisfy the minimum cost requirement in 2003 and 2004.

F. Clarify the Tax Treatment of Income and Losses on Derivatives (sec. 1306 of the bill and sec. 1221 of the Code)

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, (4) certain copyrights (or similar property), and (5) 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, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in Arkansas Best v. Commissioner 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.[141]

Treasury regulations (which were finalized in 1994) 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).

Reasons for Change

Absent an election by a commodities derivatives dealer to be treated the same as a dealer in securities under section 475, the character of the gains and losses with respect to commodities derivative financial instruments entered into by such a dealer may be unclear. The Committee is concerned that this uncertainty (i.e., the potential for capital treatment of the commodities derivatives financial instruments) could inhibit commodities derivatives dealers from entering into transactions with respect to commodities derivative financial instruments that qualify as "hedging transactions" within the meaning of the Treasury regulations under section 1221. The Committee believes that commodities derivatives financial instruments are integrally related to the ordinary course of the trade or business of commodities derivatives dealers and, therefore, such assets should be treated as ordinary assets.

The Committee further believes that ordinary character treatment is proper for business

[141] 485 U.S. 212 (1988).

hedges with respect to ordinary property. The Committee believes that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. The Treasury regulations, however, model the definition of a hedging transaction after the present-law definition contained in section 1256, which generally requires that a hedging transaction "reduces" a taxpayer's risk. The Committee believes that a "risk management" standard better describes modern business hedging practices that should be accorded ordinary character treatment.[142]

In adopting a risk management standard, however, the Committee does not intend that speculative transactions or other transactions not entered into in the normal course of a taxpayer's trade or business should qualify for ordinary character treatment, and risk management should not be interpreted so broadly as to cover such transactions. In addition, to minimize whipsaw potential, the Committee believes that it is essential for hedging transactions to be properly identified by the taxpayer when the hedging transaction is entered into.

Finally, because hedging status under present law is dependent upon the ordinary character of the property being hedged, an issue arises with respect to hedges of certain supplies, sales of which could give rise to capital gain, but which are generally consumed in the ordinary course of a taxpayer's trade or business and that would give rise to ordinary deductions. For purposes of defining a hedging transaction, Treasury regulations treat such supplies as ordinary property.[143] The Committee believes that it is appropriate to confirm this treatment by specifying that such supplies are ordinary assets.

Explanation of Provision

The bill adds three categories to the list of assets the gain or loss on which is treated as ordinary (sec. 1221). The new categories are: (1) commodities derivative financial instruments entered into by derivatives 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.

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[142] The Committee believes that the Treasury regulations appropriately interpret "risk reduction" flexibly within the constraints of present law. For example, the regulations recognize that certain transactions that economically convert an interest rate or price from a fixed rate or price to a floating rate or price may qualify as hedging transactions (Treas. Reg. sec. 1.1221-2(c)(1)(ii)(B)). Similarly, the regulations provide hedging treatment for certain written call options, hedges of aggregate risk, "dynamic hedges" (under which a taxpayer can more frequently manage or adjust its exposure to identified risk), partial hedges, "recycled" hedges (using a position entered into to hedge one asset or liability to hedge another asset or liability), and hedges of aggregate risk (Treas. Reg. sec. 1.1221-2(c)). The Committee believes that (depending on the facts) treatment of such transactions as hedging transactions is appropriate and that it also is appropriate to modernize the definition of a hedging transaction by providing risk management as the standard.

[143] Treas. Reg. sec. 1.1221-2(c)(5)(ii).

For this purpose, a commodities derivatives dealer is any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business. A commodities derivative financial instrument means a contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a fixed rate, price, or amount, or a variable rate, price, or amount, which is based on current, objectively determinable financial or economic information. This includes swaps, caps, floors, options, futures contracts, forward contracts, and similar financial instruments with respect to commodities. It does not include shares of stock in a corporation; a beneficial interest in a partnership or trust; a note, bond, debenture, or other evidence of indebtedness; or a contract to which section 1256 applies.

In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "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 is granted authority to treat transactions that manage other risks as hedging transactions. As under the present-law Treasury regulations, the transaction must be identified as a hedge of specified property. It is intended that this be the exclusive means through which the gains or losses with respect to a hedging transaction are treated as ordinary. Authority is provided for Treasury regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary is also given authority to apply these rules to related parties.

Effective Date

The provision is 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 performance of qualified professional services (sec. 1311 of the bill and sec. 448 of the Code)

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 generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an 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. A qualified personal service corporation is a corporation (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.

Reasons for Change

The Committee understands that the use of the non-accrual experience method provides the equivalent of a bad debt reserve, which generally is not available to taxpayers using the accrual method of accounting. The Committee believes that accrual method taxpayers should be treated similarly, unless there is a strong indication that different treatment is necessary to clearly reflect income or to address a particular competitive situation.

The Committee understands that accrual basis providers of qualified personal services (services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) compete on a regular basis with competitors using the cash method of accounting. The Committee believes that this competitive situation justifies the continued availability of the non-accrual experience method with respect to amounts due to be received for the performance of qualified personal services. The Committee believes that it is important to avoid the disparity of treatment between competing cash and accrual method providers of qualified personal services that could result if the non-accrual experience method were eliminated with regard to amounts to be received for such services.

Explanation of Provision

The bill provides that the non-accrual experience method will be available only for amounts to be received for the performance of qualified personal services. Amounts to be received for the performance of all other services will 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 method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount.

Effective Date

The provision is 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 will 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 is to be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.[144]

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[144] 1998-51 I.R.B. 16.

2. Impose limitation on prefunding of certain employee benefits (sec. 1312 of the bill and secs. 419A and 4976 of the Code)

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.

Reasons for Change

The Committee understands that the exception to the welfare benefit fund deduction limits for 10-or-more employer plans has been utilized to fund retirement-type benefits and avoid the dollar limitations and other rules applicable to qualified retirement plans and the deduction timing rules applicable to nonqualified deferred compensation arrangements. Congress intended the exception to apply to a multiple employer welfare benefit plan under which the relationship of a participating employer to the plan is similar to the relationship of an insured to an insurer, and did not intend the exception to apply if the liability of any employer under the plan is determined on the basis of experience rating, which can create, in effect, a single-employer plan within a 10-or-more-employer arrangement. It is difficult to identify whether experience rating is occurring with respect to the provision of some benefits, such as severance pay and certain death benefits, because of the complexity of the benefit arrangements. Therefore, the Committee believes that it is appropriate to limit the benefits for which the 10-or-more employer exception is available.

Explanation of Provision

Under the provision, the present-law exception to the deduction limit for 10-or-more employer plans is limited to plans that provide only medical benefits, disability benefits, and qualifying group-term life insurance benefits to plan beneficiaries. The Committee intends that group-term life insurance benefits do not fail to be qualifying group-term life insurance benefits solely as a result of the inclusion of de minimis ancillary benefits, as described in Treasury regulations. For purposes of this provision, qualifying group-term life insurance benefits do not include any arrangements that permit a plan beneficiary to directly or indirectly access all or part of the account value of any life insurance contract, whether through a policy loan, a partial or complete surrender of the policy, or otherwise. It is intended that qualifying group-term life insurance benefits do not include any arrangement whereby a plan beneficiary may receive a policy without a stated account value that has the potential to give rise to an account value whether through the exchange of such policy for another policy that would have an account value or otherwise. The 10-or-more employer plan exception is no longer available with respect to plans that provide supplemental unemployment compensation, severance pay, or life insurance (other than qualifying group-term life insurance) benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) apply to plans providing these benefits.

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 for providing medical benefits, disability benefits, or qualifying group-term life insurance benefits to plan beneficiaries, such portion is treated as reverting to the benefit of the employers maintaining the fund and is subject to the imposition of the 100-percent excise tax. Thus, for example, cash payments to employees upon termination of the fund, and loans or other distributions to the employee or employer, would be treated as giving rise to a reversion that is subject to the excise tax.

Under the provision, no inference is intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The provision is 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 (sec. 1313 of the bill and sections 453 and 453A of the Code)

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[145] 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.

Reasons for Change

The Committee believes that the installment method is inconsistent with the use of the accrual method of accounting and should not be allowed in situations where the disposition of property would otherwise be reported using the accrual method. The Committee is concerned that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.

The Committee also believes that the installment method, where its use is appropriate, should not serve to defer the recognition of gain beyond the time when funds are received. Accordingly, the Committee believes that proceeds of a loan should be treated in the same manner as a payment on an installment obligation if the loan is dependent on the existence of the installment obligation, such as where the loan is secured by the installment obligation or can be satisfied by the delivery of the installment obligation.

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[145] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

Explanation of Provision

Prohibition on the use of the installment method for accrual method dispositions

The provision generally prohibits 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 provision does 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 provision also does 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 provision 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 provision would not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modifications to the pledge rule

The provision modifies 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 provision, 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 modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does 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 provision is effective for sales or other dispositions entered into on or after the date of enactment.

4. Limit conversion of character of Income from constructive ownership transactions (sec. 1314 of the bill and new sec. 1260 of the Code)

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.[146]

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 an item 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).

Reasons for Change

The Committee is concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain. Of particular concern are derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts results in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity. The current rules designed to prevent the conversion of ordinary income into capital gain (sec. 1258) only apply to transactions where the taxpayer's expected return is attributable solely to the time value of the taxpayer's net investment.

One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer[147] whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer any depreciation in the value of the notional

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[146] Section 1234A, as amended by the Taxpayer Relief Act of 1997.

[147] Assuming the securities dealer purchases the financial asset, the dealer would mark both the financial asset and the contractual arrangement to market under Code sec. 475, and the economic (and tax) consequences of the two positions would offset each other.

investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.

Explanation of Provision

The provision limits 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 is limited to the amount of such gain the taxpayer would have had if the taxpayer held the asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The bill does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is 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 the financial asset, (2) enters into a forward contract to acquire the 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.

The Committee anticipates that Treasury regulations, when issued, will provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction.[148]

A "financial asset" is 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" refers to (1) a regulated investment company, (2) a real estate investment trust, (3) a real estate mortgage investment conduit, (4) an S corporation, (5) a partnership, (6) a trust, (7) a common trust fund, (8) a passive foreign investment company,[149] (9) a foreign personal holding company, and (10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the "net underlying long-term

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[148] It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

[149] For this purpose, a passive foreign investment company includes an investment company that is also a controlled foreign corporation.

capital gain" attributable to the financial asset. The net underlying long-term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset).[150] The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates in section 1(h).

Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. 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 gross income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate[151] during the term of the constructive ownership transaction.

Example 2: Same facts as in example 1, and assume the applicable Federal rate on December 31, 2002, is six percent. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.[152]

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[150] A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero. To the extent that the economic positions of the taxpayer and the counterparty do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish.

[151] The accrual rate is the applicable Federal rate on the day the transaction closed.

[152] In general this allocation of gain is determined by the following formula. Let Y be the total amount of recharacterized gain. Let G_i be the amount of recharacterized gain allocated to year i. Let r be the applicable Federal rate. Assume the term of the constructive ownership transaction

A taxpayer is 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.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contracts, options, or other positions that are part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).

The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the Code or regulations. The provision also does not apply to transactions entered into by tax-exempt organizations and foreign taxpayers.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

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is n years. Then,

(1) $Y = \sum_{i=1}^{n} G_i$, and

(2) $G_{i+1} = G_i (1+r)$.

Substituting equation (2) into equation (1) produces equation (3) below.

(3) $Y = G_1 \cdot \sum_{i=0}^{n-1} (1+r)^i$.

For a given term, n, a given applicable Federal rate, r, and a given recharacterized gain, Y, equation (3) can be used to determine the income allocated to the first year and equation (2) can be used to allocate income to subsequent years.

Effective Date

The provision applies to transactions entered into on or after July 12, 1999. For this purpose, the Committee intends that a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999 which extends or otherwise modifies the terms of a transaction entered into prior to such date is treated as a transaction entered into on or after July 12, 1999.

5. Denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements (sec. 1315 of the bill and new sec. 501(c)(28) of the Code)

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.[153]

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)).

Reasons for Change

The Committee is concerned about an abusive scheme[154] referred to as charitable split-dollar life insurance, and the provision is designed to stop the spread of this scheme. Under this scheme, taxpayers typically transfer money to a charity, which the charity then uses to pay premiums for cash value life insurance on the transferor or another person. The beneficiaries under the life insurance contract typically include members of the transferor's family (either directly or through a family trust or family partnership). Having passed the money through a charity, the transferor claims a charitable contribution deduction for money that is actually being

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[153] United States v. American Bar Endowment, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

[154] "A Popular Tax Shelter for 'Angry Affluent' Prompts Ire of Others," Wall Street Journal, Jan. 22, 1999, p. A1; "U.S. Treasury Officials Investigating Charitable Split-Dollar Insurance Plan," Wall Street Journal, Jan. 29, 1999, p. B5; "Brilliant Deduction?," The Chronicle of Philanthropy, Aug. 13, 1998, p. 24; "Charitable Reverse Split-Dollar: Bonanza or Booby Trap," Journal of Gift Planning, 2nd quarter 1998.

used to benefit the transferor and his or her family. If the transferor or the transferor's family paid the premium directly, the payment would not be deductible. Although the charity eventually may get some of the benefit under the life insurance contract, it does not have unfettered use of the transferred funds.

The Committee is concerned that this type of transaction represents an abuse of the charitable contribution deduction. The Committee is also concerned that the charity often gets relatively little benefit from this type of scheme, and serves merely as a conduit or accommodation party, which the Committee does not view as appropriate for an organization with tax-exempt status. In substance, the charity receives a transfer of a partial interest in an insurance policy, for which no charitable contribution deduction is allowed. While there is no basis under present law for allowing a charitable contribution deduction in these circumstances, the Committee intends that the provision stop the marketing of these transactions immediately.

Therefore, the provision clarifies present law by specifically denying a charitable contribution deduction for a transfer to a charity if the charity directly or indirectly pays or paid any premium on a life insurance, annuity or endowment contract in connection with the transfer, and any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other noncharitable person chosen by the transferor. In addition, the provision clarifies present law by specifically denying the deduction for a charitable contribution if, in connection with a transfer to the charity, there is an understanding or expectation that any person will directly or indirectly pay any premium on any such contract.

The provision provides that certain persons are not treated as indirect beneficiaries, in certain cases in which a charitable organization purchases an annuity contract to fund an obligation to pay a charitable gift annuity. The provision also provides that a person is not treated as an indirect beneficiary solely by reason of being a noncharitable recipient of an annuity or unitrust amount paid by a charitable remainder trust that holds a life insurance, annuity or endowment contract. The rationale for these rules is that the amount of the charitable contribution deduction is limited under present law to the value of the charitable organization's interest. Congress has previously enacted rules designed to prevent a charitable contribution deduction for the value of any personal benefit to the donor in these circumstances, and the Committee expects that the personal benefit to the donor is appropriately valued.

Further, the provision imposes an excise tax on the charity, equal to the amount of the premiums paid by the charity. Finally, the provision requires a charity to report annually to the Internal Revenue Service the amount of premiums subject to this excise tax and information about the beneficiaries under the contract.

Explanation of Provision

Deduction denial

The provision[155] restates 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 is 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 is 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 is 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 is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is 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) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is 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 beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

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 is not 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

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[155] The provision is similar to H.R. 630, introduced by Mr. Archer for himself and for Mr. Rangel (106th Cong., 1st Sess.).

to the charitable organization).

Under the provision, an individual's family consists 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 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) are 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 provision) 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 is not 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 is 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 provision is 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 provision imposes 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 provision (without regard to when the transfer to the charitable organization was made). The excise tax does 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 provision, payments are 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 provision requires 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 provision, 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 is 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 provision are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The provision provides for the promulgation of regulations necessary or appropriate to carry out the purposes of the provisions, including regulations to prevent the avoidance of the purposes of the provision. For example, it is intended that regulations prevent avoidance of the purposes of the provision 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 provision applies to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax provision applies to premiums paid after the date of enactment. The reporting provision applies to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the provision applied to premiums paid after that date).

No inference is intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The provision does 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 provision.

6. Modify estimated tax rules for closely held REIT dividends (sec. 1316 of the bill and sec. 6655 of the Code)

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.

Reasons for Change

The Committee is concerned that REITs may be used to defer estimated taxes. Income producing property might be acquired in or transferred to a REIT, and a dividend paid from the REIT only at the end of the year. So long as the dividend is paid by year end (or within a certain period after year end), the REIT pays no tax on the dividend, while the shareholder of the REIT does not include the payment in income until the dividend is paid. Thus, the income from the assets is not counted in the earlier quarters of the year, for purposes of the shareholder's estimated tax.

The Committee is concerned that this type of situation is most likely to occur in cases where the REIT is relatively closely held and may be used to structure payments for the benefit of significant shareholders. In such situations, the Committee believes that persons who are significant shareholders in the REIT should be able to obtain sufficient information regarding the quarterly income of the REIT to determine their share of that income for estimated tax purposes.

Explanation of Provision

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 is 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 is defined as one in which at least 50 percent of the vote or value is owed by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

Effective Date

The provision is effective for estimated tax payments due on or after September 15, 1999.

7. Prohibited allocations of stock in an ESOP of an S corporation (sec. 1317 of the bill and secs. 409 and 4979A of the Code)

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.

Reasons for Change

In enacting the provision relating to S corporation ESOPs in 1997, the Congress was concerned that the prior-law rule imposed double taxation on such ESOPs and ESOP participants. The Congress believed such a result was unfair. Since the enactment of the 1997 Act, however, the Committee has become aware that the present-law rule provides inappropriate deferral and tax avoidance in some case.

The Committee believes that S corporations should be able to establish ESOPs. The Committee does not believe, however, that the ESOP should provide inappropriate deferral or tax avoidance. The Committee is particularly concerned at this time about S corporations owned by a small group of individuals who may use the present-law rule to avoid or defer taxes.

Explanation of Provision

Under the provision, if there is a prohibited allocation of stock to a disqualified person under an ESOP sponsored by an S corporation (a "Sub S ESOP") for a nonallocation year: (1) an excise tax is imposed on the employer equal to 50 percent of the amount involved in the prohibited allocation; and (2) the stock allocated in the prohibited allocation is treated as distributed to the disqualified individual.

A nonallocation year means any plan year of a Sub S ESOP if, at any time during the plan year, disqualified individuals own at least 50 percent of the number of outstanding shares of the S corporation.

An individual is a disqualified person if the individual is either (1) a member of a "deemed 20-percent shareholder group" or (2) a "deemed 10-percent shareholder". An individual is a member of a "deemed 20-percent shareholder group" if the number of deemed-owned shares of the individual and his or her family members is at least 20 percent of the number of outstanding shares of the corporation. An individual is a deemed 10-percent shareholder if the individual is not a member of a deemed 20-percent shareholder group and the number of the individual's deemed-owned shares is at least 10 percent of the number of outstanding shares of stock of the corporation.

"Deemed-owned shares" mean: (1) stock allocated to the account of the individual under the ESOP, and (2) the individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether disqualified individuals own 50 percent or more of the outstanding stock of the corporation, deemed-owned shares and shares owned directly by an individual are taken into account. The family attribution rules of section 318 would apply, modified to include certain other family members, as described below.

Under the provision, family members of an individual include (1) the spouse of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

The Secretary is directed to prescribe rules under which holders of options, restricted stock and similar interests are or are not treated as owning stock attributable to such interests as appropriate to carry out the purposes of the provision. For example, it is intended that such interests would be taken into account if so doing would result in disqualified individuals owning at least 50 percent of the stock of the corporation and that such interests would not be taken into account if so doing would result in disqualified individuals owning less than 50 percent of the stock of the corporation.

The following example illustrates the provision.

> 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 provision is generally effective with respect to years beginning after December 31, 2000. In the case of an ESOP established after July 14, 1999, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after July 14, 1999.

8. Modify anti-abuse rules related to assumption of liabilities (sec. 1318 of the bill and sec. 357 of the Code)

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. If the transferee assumes liabilities in excess of the basis of assets transferred, the transferor recognizes gain in the amount of the excess. However, this gain recognition rule does not apply if the assumption of a liability is treated as boot under the tax avoidance rule. Stock basis is reduced, however, for an assumption. For other liabilities (where the assumption is not treated as boot under the tax avoidance rule), no gain recognition or basis reduction is required for the assumption of a liability that would give rise to a deduction.

Similar rules apply in connection with certain tax-free reorganizations.

Reasons for Change

The Committee is concerned that the anti-abuse rule related to the assumption of liabilities may be inadequate to address the concerns that underlie the provision, given the high standard before it is applicable. A standard of "the" principal purpose may be difficult to prove. In addition, taxpayers may contend that the "exchange" itself is not the tax-avoidance transaction, even though the exchange may make the tax avoidance possible.

As one example of a transaction that concerns the Committee, a transferor corporation may transfer assets with a fair market value basis (as one example, a note of another member of the corporate group) in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future, but capable of current valuation. The transferor claims a high basis for the stock of the transferee held with respect to this transfer, because the basis of the assets is taken into account, while the taxpayer contends that the assumed liability does not reduce stock basis under current law. However, the value of the transferee stock in the hands of the transferor is nominal, because of the liability that offsets virtually all the value of the assets. The transferor may then attempt to accelerate the deduction that would be attributable to the liability, by selling or exchanging the transferee stock at a loss. Furthermore, the transferee (which may still be a member of the consolidated group filing a tax return with the transferor) might take the position that it is entitled to deduct the payments on the liability, effectively duplicating the deduction attributable to the liability.

The Committee believes that a change in the standard under section 357(b) is desirable, to affect transactions where the taxpayer has "a principal purpose" of tax avoidance. A taxpayer may have "a principal purpose" of tax avoidance even though it is outweighed by other purposes (taken together or separately).

Explanation of Provision

The provision deletes the limitation that the assumption of liabilities anti-abuse rule only applies to tax avoidance on the exchange itself, and changes "the principal purpose" standard to "a principal purpose." The provision also affects the basis rule that requires 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.[156]

Effective Date

The provision is effective for assumptions of liabilities on or after July 15, 1999.

[156] Section 357(b)(1) liabilities are not within the scope of section 357(c)(3) or section 358(d)(2). Thus, the transferee's assumption of a liability under section 357(b)(1), as modified by the provision, is treated as the transferor's receipt of money for purposes of 358 and related provisions.

9. Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions (sec. 1319 of the bill and secs. 351 and 721 of the Code)

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).

Explanation of Provision

The provision treats 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. In the case of a transfer of less than all of the substantial rights, the transferor is required to allocate the basis of the intangible between the retained rights and the transferred rights based upon their respective fair market values.

No inference is intended as to the treatment of these or similar transactions prior to the effective date.

Effective Date

The provision is effective for transfers on or after the date of enactment.

10. Modify treatment of closely-held REITs (sec 1320 of the bill and sec. 856 of the Code)

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.

Reasons for Change

The Committee is aware of a number of situations in which a closely held REIT may be used as a conduit to recharacterize items of income. Some cases causing concern have already been addressed by legislation (e.g., "liquidating reits," which attempted to eliminate tax on income for a period of years) or by regulations (e.g., "step-down preferred" stock, which attempted to provide a corporate borrower with a deduction for payment of principal as well as interest on a loan).

Despite these actions, the Committee is concerned that closely-held REITs may still be used to obtain other tax benefits, chiefly from the ability to recharacterize the income earned by the REIT as a dividend to the REIT owners, as well as to control the timing of such a dividend. Therefore, the provision adds new ownership restrictions designed to limit opportunities for inappropriate income recharacterization.

In certain limited cases, the Committee believes that additional time to satisfy the new requirements should be granted to enable the REIT to establish an operating history before bringing the REIT public. The Committee believes that, in addition to other indicia, evidence of significant and steady growth of the REIT is an important component in demonstrating an intent to bring the REIT public.

Explanation of Provision

The provision imposes 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 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 apply (secs. 856(d)(5) and 856(h)(3)). The provision does not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception applies for a limited period to certain “incubator REITs”. An incubator REIT is 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 does not apply to an electing incubator REIT until the end of the REIT’s third taxable year; and can 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 is imposed on each of the corporation’s directors for each taxable year for which the election was in effect.

For purposes of determining whether a corporation has met the requirement that it annually increase the value of its real estate assets by 10 percent, the following rules shall apply. First, values shall be based on cost and properly capitalizable expenditures with no adjustment for depreciation. Second, the test shall be applied by comparing the value of assets at the end of the first taxable year with those at the end of the second taxable year and by similar successive taxable year comparisons during the eligibility period. Third, if a corporation fails the 10 percent comparison test for one taxable year, it may remedy the failure by increasing the value of real estate assets by 25 percent in the following taxable year, provided it meets all the other eligibility period requirements in that following taxable year.

A going public transaction is 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 provision is effective for taxable years ending after July 14, 1999. Any entity that elects (or has elected) 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.

For purposes of the transition rules, the significant business assets or activities in place on July 14, 1999, must be real estate assets and activities of a type that would be qualified real estate assets and would produce qualified real estate related income for a REIT.

11. Distributions by a partnership to a corporate partner of stock in another corporation (sec. 1321 of the bill and sec. 732 of the Code)

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.[157]

Reasons for Change

The Committee is concerned that the downward adjustment to the basis of property distributed by a partnership may be nullified if the distributed property is corporate stock. The

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[157] 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).

distributed corporation can be liquidated by the corporate partner, so that the stock basis adjustment has no effect. Similarly, if the corporations file a consolidated return, their taxable income may be computed without reference to the downward adjustment to the basis of the stock. These results can occur either if the partnership has contributed property to the distributed corporation, or if the property was held by the corporation before the distribution. Therefore, the provision requires a basis reduction to the property of the distributed corporation.

Explanation of Provision

In general

The provision provides 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 applies if, after the distribution, the corporate partner controls the distributed corporation.

Amount of the basis reduction

Under the provision, the amount of the reduction in basis of property of the distributed corporation generally equals 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 provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may 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 may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation may not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

The provision provides 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. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount. 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 provision. The corporate partner's basis in the stock of the distributed corporation would also be increased by $100 in this example, under the provision.

The basis reduction is to be allocated among assets of the controlled corporation in accordance with the rules provided under section 732(c).

Partnership distributions resulting in control

The basis reduction generally applies 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 means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

The provision applies 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 provision does 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 provision, a corporation is 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)).

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

Effective Date

The provision is effective for distributions made after July 14, 1999.

TITLE XIV. TAX TECHNICAL CORRECTIONS

Except as otherwise provided, the technical corrections contained in the bill generally are effective as if included in the originally enacted related legislation.

Amendments Related to the Tax and Trade Relief Extension Act of 1998 (sec. 1401 of the bill)

Exempt organizations.--The provision clarifies that nonexempt charitable trusts and nonexempt private foundations are subject to the public disclosure requirements of section 6104(d).

Capital gains.--The provision clarifies 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.

Amendments Related to the Internal Revenue Service Restructuring and Reform Act of 1998 (sec. 1402 of the bill)

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 provision clarifies 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 provision adds to section 6110(g)(5)(A), after the words technical advice memorandum, "or Chief Counsel advice."

Amendments Related to the Taxpayer Relief Act of 1997 (sec. 1403 of the bill)

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 does not account for the tax-free nature of certain Roth IRA distributions. The provision extends 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 provision treats 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 provision provides that the Tax Court also has jurisdiction over the amount.

Amendments to Other Acts (sec. 1404 of the bill)

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 tests had been identical until then. The provision conforms 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 provisions 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 contribution 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 $1,100 ($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 provision provides that the contributions for the spouse with the lesser income cannot exceed the combined earned income of the spouses. The provision is 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 provision clarifies 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 provision clarifies 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 provision adds 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 provision amends 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 (sec. 1405 of the bill)

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 provision corrects the reference in section 67(f).

Excess contributions.--The provision modifies 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 provision deletes 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 provision corrects 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 provision names 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 provision changes this language so that it refers to compensation at the lowest rate prescribed for Senior Executive Service (SES) positions.

XV. COMPLIANCE WITH CONGRESSIONAL BUDGET ACT
(secs. 1501 and 1502 of the bill)

Present Law

Reconciliation is a procedure under the Congressional Budget Act of 1974 ("the Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the deficit reduction goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) it does not produce a change in outlays or revenues;

(2) it produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) it is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) it produces a change in outlays or revenues which is merely incidental to the non-budgetary components of the provision;

(5) it would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; and

(6) it recommends changes in Social Security.

Reasons for Change

The Committee believes that it is difficult to apply the Byrd rule (which was intended to promote deficit reduction during a time of budget deficits) in an era of budget surpluses. However, the Byrd rule is a part of the Budget Act which governs the budget reconciliation process and the Committee intends to comply with the Budget Act.

Explanation of Provision

The bill, to ensure compliance with the Budget Act, provides that all provisions of, and amendments made by, this Act which are in effect on September 30, 2009, shall cease to apply as of such date, and shall begin to apply again as of October 1, 2009.

Effective Date

The provision is effective on date of enactment.

III. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the provisions of the bill as reported.

The bill, as reported, is estimated to have the following budget effects for fiscal years 1999-2009.

[Insert revenue table]

ESTIMATED BUDGET EFFECTS OF THE "TAXPAYER REFUND ACT OF 1999,"
AS APPROVED BY THE COMMITTEE ON FINANCE ON JULY 21, 1999

Fiscal Years 1999 - 2009

[Millions of Dollars]

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
Title I. Broad-Based Tax Relief Provisions														
A. Reduce 15% Income Tax Rate to 14% in 2001 and thereafter	tyba 12/31/00	---	---	-15,798	-23,062	-23,685	-24,245	-24,801	-25,371	-25,874	-26,357	-26,857	-86,790	-216,050
B. Increase the Width of the 14% Bracket by $2,000 ($4,000 for Joint Returns) Beginning in 2005, and by $2,500 ($5,000 for Joint Returns) Beginning in 2007	tyba 12/31/04	---	---	---	---	---	---	-10,156	-14,720	-17,417	-19,098	-20,062	---	-81,453
Total of Broad-Based Tax Relief Provisions		**---**	**---**	**-15,798**	**-23,062**	**-23,685**	**-24,245**	**-34,957**	**-40,091**	**-43,291**	**-45,455**	**-46,919**	**-86,790**	**-297,503**
Title II. Family Tax Relief Provisions														
A. Election to Calculate Combined Tax for a Married Couple Filing a Joint Return - allow married couples filing joint returns to elect to file single returns on a combined form; both must itemize deductions or take standard deduction; income follows ownership (50% split on jointly owned assets)	tyba 12/31/04	---	---	---	---	---	---	-16,226	-23,478	-23,795	-24,121	-24,460	---	-112,080
B. Marriage Penalty Relief Relating to the Earned Income Credit - adjust the income starting and ending point for the earned income credit for married couples filing joint returns by $2,000 indexed after 2005 (phaseout rate stays the same)	tyba 12/31/04	---	---	---	---	---	---	-268	-1,344	-1,349	-1,336	-1,316	---	-5,613
C. Expand the Exclusion from Income for Certain Foster Care Payments	tyba 12/31/99	---	-6	-14	-21	-29	-37	-44	-52	-61	-70	-80	-106	-414
D. Increase and Expand the Dependent Care Tax Credit - increase percentage to 50% for AGI under $30,000 and index maximum expense limits for inflation; percentage phases down in 1% increments for each $1,000 of AGI over $30,000 (percentage does not go below 20%)	tyba 12/31/00	---	---	-191	-762	-762	-773	-764	-761	-755	-729	-733	-2,488	-6,231
E. Tax Credit for Employer-Provided Child Care Facilities (maximum $150,000)	tyba 12/31/00	---	---	-46	-91	-108	-127	-146	-161	-175	-188	-202	-372	-1,245
F. Modify the Individual Alternative Minimum Tax - make permanent the present-law provision to allow nonrefundable personal credits fully; allow personal exemption against the AMT	tyba 12/31/98 & tyba 12/31/04	---	-980	-1,073	-1,744	-2,250	-3,039	-7,866	-13,000	-17,115	-21,910	-27,134	-9,086	-96,111
Total of Family Tax Relief Provisions		**---**	**-986**	**-1,324**	**-2,618**	**-3,149**	**-3,976**	**-25,314**	**-38,796**	**-43,250**	**-48,354**	**-53,925**	**-12,052**	**-221,694**

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
Title III. Retirement Savings Tax Relief Provisions														
A. Individual Retirement Arrangements														
1. Increase the annual contribution limit for deductible, nondeductible, and Roth IRAs in $1,000 increments until it reaches $5,000 and index for inflation thereafter, beginning in 2001	tyba 12/31/00	---	---	-618	-1,878	-3,068	-3,968	-4,701	-5,444	-6,199	-6,882	-7,659	-9,532	-40,418
2. Increase the AGI limitation for contributions to a deductible IRA - $2,000 ($4,000 joint returns) for 2008, and $2,500 ($5,000 joint returns) for 2009 through 2010; index in years thereafter	tyba 12/31/07	---	---	---	---	---	---	---	---	---	-200	-774	---	-975
3. Eliminate the AGI limitation for contributions to a Roth IRA	tyba 12/31/00	---	---	-2	-102	-342	-655	-1,002	-1,347	-1,691	-2,049	-2,406	-1,101	-9,596
4. Increase the income limit to $1 million for conversions of an IRA to a Roth IRA	tyba 12/31/02	---	---	---	---	1,330	3,484	1,326	-2,257	-3,175	-1,803	-347	4,814	-1,441
5. 85% tax credit for matching contributions by financial institutions to individual development accounts, effective for 2001 through 2005; maximum tax credit $300 per account per year	tyba 12/31/00	---	---	-66	-149	-160	-177	-190	-105	2	2	2	-552	-840
6. U.S. legal tender coins to be qualified investments for IRAs, if traded on national exchange	tyba 12/31/99	*Negligible Revenue Effect*												
Subtotal of Individual Retirement Arrangements …………………………………………		---	---	-686	-2,129	-2,240	-1,316	-4,567	-9,153	-11,063	-10,932	-11,184	-6,371	-53,270
B. Expanding Coverage														
1. Option to treat elective deferrals under a 401(k) plan or tax-sheltered annuities as after-tax contributions	pyba 12/31/00	---	---	50	100	131	144	89	-2	-104	-218	-345	426	-155
2. Increase contribution and benefit limits:														
a. Increase limitation on exclusion for elective deferrals from $10,000 to: $11,000 in 2001, $12,000 in 2002, $13,000 in 2003, $14,000 in 2004, $15,000 in 2005; index in $500 increments thereafter [1] [2]	yba 12/31/00	---	---	-131	-315	-465	-574	-658	-715	-764	-808	-849	-1,485	-5,279
b. Increase section 457 limit from $8,000 to $9,000 in 2001, $10,000 in 2002, $11,000 in 2003, $12,000 in 2004, and index in $500 increments thereafter	yba 12/31/00	---	---	-13	-33	-55	-79	-111	-128	-136	-145	-153	-180	-854
c. Increase limitation on SIMPLE elective contributions from $6,000 to $7,000 in 2001, $8,000 in 2002, $9,000 in 2003, $10,000 in 2004; index in $500 increments thereafter [1] [2]	yba 12/31/00	---	---	-5	-14	-22	-27	-29	-29	-30	-31	-33	-67	-219
3. Plan loans for subchapter S owners, partners, and sole proprietors	yba 12/31/00	---	---	-20	-30	-32	-35	-37	-39	-41	-44	-46	-117	-325
4. Elective deferrals not taken into account for purposes of deduction limits	yba 12/31/00	---	---	-38	-71	-81	-85	-89	-93	-97	-101	-104	-275	-759
5. Reduce PBGC premium for new plans of small employers [3]	pea 12/31/00	---	---	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-1	-3
6. Phase-in of additional PBGC premium for new plans [3]	pea 12/31/00	---	---	---	-1	-1	-1	-2	-2	-2	-2	-2	-4	-12
7. Elimination of user fee for requests regarding new employer pension plans [3]	rma 12/31/00	---	---	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	[4]	-8	-18
8. SAFE annuities and trusts	pyba 12/31/00	---	---	-22	-124	-273	-409	-474	-454	-460	-480	-492	-828	-3,188
9. Modify top-heavy rules	pyba 12/31/00	---	---	-3	-5	-6	-7	-8	-9	-10	-11	-12	-21	-72
Subtotal of Expanding Coverage ………………………………………………………………		---	---	-184	-495	-806	-1,075	-1,321	-1,473	-1,646	-1,842	-2,038	-2,560	-10,884

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
C. Enhancing Fairness for Women														
1. Increase in maximum contribution limits for IRAs and other pension plans for individuals age 50 and above by 10% annually beginning in 2001, not to exceed 50%	cmi tyba 12/31/00	---	---	-136	-310	-329	-323	-353	-395	-443	-493	-565	-1,097	-3,346
2. Equitable treatment for contributions of employees to defined contribution plans [1]	yba 12/31/00	---	---	-50	-75	-81	-87	-92	-97	-103	-107	-110	-294	-804
3. Clarification of tax treatment of division of section 457 plan benefits upon divorce	tdapma 12/31/00	*Negligible Revenue Effect*												
4. Modification of safe harbor relief for hardship withdrawals from 401(k) plans	aiii TRA'97	*Negligible Revenue Effect*												
5. Faster vesting of certain employer matching contributions	pyba 12/31/00	*Negligible Revenue Effect*												
Subtotal of Enhancing Fairness for Women		---	---	-186	-385	-410	-410	-445	-492	-546	-600	-675	-1,391	-4,150
D. Increasing Portability for Participants														
1. Rollovers allowed among governmental section 457, section 403(b), and qualified plans	dma 12/31/00	---	---	-7	-11	-12	-12	-12	-13	-13	-13	-14	-41	-106
2. Rollovers of IRAs to workplace retirement plans	dma 12/31/00	*Negligible Revenue Effect*												
3. Rollovers of after-tax retirement plan contributions	dma 12/31/00	*Negligible Revenue Effect*												
4. Waiver of 60-day rule	dma 12/31/00	*Negligible Revenue Effect*												
5. Treatment of forms of qualified plan distributions	yba 12/31/00	*Negligible Revenue Effect*												
6. Rationalization of restrictions on distributions	da 12/31/00	*Negligible Revenue Effect*												
7. Purchase of service credit in governmental defined benefit plans	ta 12/31/00	*Negligible Revenue Effect*												
8. Employers may disregard rollovers for cash-out amounts	da 12/31/00	*Negligible Revenue Effect*												
Subtotal of Increasing Portability for Participants		---	---	-7	-11	-12	-12	-12	-13	-13	-13	-14	-41	-106
E. Strengthening Pension Security and Enforcement														
1. Phase-in repeal of 150% of current liability funding limit; extend maximum deduction rule	yba 12/31/00	---	---	-7	-21	-33	-36	-36	-38	-38	-39	-41	-98	-290
2. Missing plan participants	[5]	*Negligible Revenue Effect*												
3. Treatment of multiemployer plans under section 415	yba 12/31/00	---	---	-4	-7	-8	-8	-8	-8	-9	-9	-9	-26	-69
4. Excise tax relief for sound pension funding	yba 12/31/00	---	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-11	-26
5. Notice of significant reduction in plan benefit accruals	pateo/a DOE	*Negligible Revenue Effect*												
6. Protection of investment of employee contributions in 401(k) plans	yba 12/31/00	*No Revenue Effect*												
Subtotal of Strengthening Pension Security and Enforcement		---	---	-13	-31	-44	-47	-47	-49	-50	-51	-53	-135	-385
F. Encouraging Retirement Education														
1. Periodic pension benefit statements	yba 12/31/00	*No Revenue Effect*												
2. Treatment of employer-provided retirement advice	yba 12/31/00	*Negligible Revenue Effect*												
Subtotal of Encouraging Retirement Education		*Negligible Revenue Effect*												
G. Reducing Regulatory Burdens														
1. Flexibility in nondiscrimination and line of business rules [6]	DOE	*Negligible Revenue Effect*												
2. Modification of timing of plan valuations	pyba 12/31/00	*Negligible Revenue Effect*												
3. Rules for substantial owner benefits in terminated plans [3]	noitta 12/31/00	*Negligible Revenue Effect*												
4. ESOP dividends may be reinvested without loss of dividend deduction	tyba 12/31/00	---	---	-19	-44	-56	-61	-63	-66	-69	-71	-74	-180	-523

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
5. Notice and consent period regarding distributions	yba 12/31/00	*No Revenue Effect*												
6. Repeal transition rule relating to certain highly compensated employees	pyba 12/31/99	---	-1	-2	-3	-3	-3	-3	-4	-4	-4	-4	-12	-31
7. Employees of tax-exempt entities [6]	DOE	*Negligible Revenue Effect*												
8. Provisions relating to plan amendments	DOE	*No Revenue Effect*												
9. Extension to international organization of moratorium on application of certain nondiscrimination rules applicable to State and local government plans	yba 12/31/00	*Negligible Revenue Effect*												
10. Annual report dissemination	yba 12/31/98	*No Revenue Effect*												
11. Clarification of exclusion for employer-provided transit passes	tyba 12/31/99	---	-4	-8	-10	-13	-14	-15	-15	-16	-16	-16	-49	-127
Subtotal of Reducing Regulatory Burdens …………………………………………………		---	-5	-29	-57	-72	-78	-81	-85	-89	-91	-94	-241	-681
Total of Retirement Savings Tax Relief Provisions ……………………………………		**---**	**-5**	**-1,105**	**-3,108**	**-3,584**	**-2,938**	**-6,473**	**-11,265**	**-13,407**	**-13,529**	**-14,058**	**-10,739**	**-69,476**
Title IV. Education Tax Relief Provisions														
A. Student Loan Interest Deduction - increase student loan deduction income limits for single taxpayers by $10,000 and adjust the income limits for married couples filing joint returns to twice that of a single taxpayer; phase-out range of $15,000 for both; repeal 60-month rule for everyone	tyea 12/31/99	---	-55	-228	-261	-294	-332	-343	-354	-366	-378	-390	-1,170	-3,000
B. Prepaid Savings Plans - State-sponsored plans: exclusions for distributions for education expenses, beginning in 2000; private plans: tax deferral on income beginning in 2000; exclusion for distributions for education expenses beginning in 2004; allow tax-free education withdrawals from prepaid savings plans and education IRAs as long as they are not used for the same expenses for which HOPE or Lifetime Learning credits are claimed, beginning in 2000; miscellaneous other changes (clarify definition; one rollover per year)	tyba 12/31/99	---	-8	-26	-41	-61	-87	-120	-155	-191	-225	-261	-222	-1,175
C. Exclude from Tax Awards Under the Following Programs: the National Health Corps Scholarship program, beginning in 1994; and F. Edward Hebert Armed Forces Health Professions Scholarship program, beginning in 1994	tyba 12/31/93	---	-2	-1	-1	-1	[7]	[7]	-1	-1	-1	-1	-5	-8
D. Permanent Extension of Employer Provided Educational Assistance - extend the exclusion for undergraduate courses; add the exclusion for graduate level courses [8]	1/1/00	---	-254	-510	-598	-637	-682	-731	-783	-839	-899	-964	-2,682	-6,898
E. Liberalize Tax-Exempt Financing Rules for Public School Construction														
1. Increase the school construction small issue arbitrage rebate exception school construction from $10 million to $15 million	bia 12/31/99	---	[7]	-2	-4	-5	-13	-14	-14	-15	-16	-17	-25	-102
2. Provide for issuance of tax-exempt private activity bonds for qualified education facilities with annual volume cap the greater of $10 per resident or $5 million	bia 12/31/99	---	-4	-16	-33	-52	-76	-103	-133	-163	-192	-220	-181	-992

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
3. Allow Federal Home Loan Bank to guarantee school construction bonds, capped at $500 million a year	[9]	*No Revenue Effect*												
Total of Education Tax Relief Provisions		**---**	**-323**	**-783**	**-938**	**-1,050**	**-1,190**	**-1,311**	**-1,440**	**-1,575**	**-1,711**	**-1,853**	**-4,285**	**-12,175**
Title V. Health Care Tax Relief Provisions														
A. Provide an above-the-line deduction for health insurance expenses for which the taxpayer pays at least 50% of the premium, phased in as follows: 25% in 2001 through 2003, 50% in 2004 through 2005, 100% in 2006 and thereafter; for purposes of the 50% payment rule, all health plans of a single employer are combined; does not apply to any month in which the taxpayer Is enrolled in Medicare, Medicaid, Champus, VA, Indian Health service, Children's Health Insurance or Federal Employees Health Benefits (non-COBRA) programs	tyba 12/31/00	---	---	-416	-1,289	-1,379	-2,014	-3,241	-4,781	-7,783	-8,299	-8,848	-5,097	-38,050
B. Long-Term Care Insurance Provisions														
1. Provide an above-the-line deduction for long-term care insurance expenses for which the taxpayer pays at least 50% of the premium, phased in as follows: 25% in 2001 through 2003, 50% in 2004 through 2005;100% in 2006 and thereafter	tyba 12/31/00	---	---	-40	-276	-328	-425	-801	-1,005	-1,908	-2,027	-2,146	-1,069	-8,956
2. Allow long-term care insurance to be offered as part of cafeteria plans [10]	tyba 12/31/00	---	---	-99	-136	-151	-165	-173	-185	-184	-215	-247	-551	-1,555
C. Provide an Additional Dependency Deduction to Caretakers of Elderly Family Members	tyba 12/31/99	---	-180	-266	-262	-265	-268	-336	-388	-414	-438	-463	-1,240	-3,279
D. Add Streptococcus Pneumoniae Vaccine to the List of Taxable Vaccines; Reduce Excise Tax on All Taxable Vaccines to $0.25 Per Dose Beginning in 2005; Study of Vaccine Program	[11]	---	4	7	9	10	10	-62	-87	-87	-88	-89	39	-374
Total of Health Care Tax Relief Provisions		**---**	**-176**	**-814**	**-1,954**	**-2,113**	**-2,862**	**-4,613**	**-6,446**	**-10,376**	**-11,067**	**-11,793**	**-7,918**	**-52,214**
Title VI. Small Business Tax Relief Provisions														
A. Accelerate 100% Deduction for Health Insurance of Self-Employed Individuals	tyba 12/31/99	---	-245	-1,007	-1,040	-657	---	---	---	---	---	---	-2,949	-2,949
B. Increase Section 179 Expensing to $30,000	tyba 12/31/99	---	-790	-880	-189	-95	2	-31	-90	-142	-157	-160	-1,954	-2,533
C. Accelerate Repeal of the FUTA Surtax	lpo/a 1/1/05	---	---	---	---	---	---	-1,029	-421	-21	1,058	413	---	---
D. Coordinate Farmer Income Averaging and the AMT	tyba 12/31/99	---	[7]	-1	-1	-1	-2	-2	-2	-3	-4	-5	-6	-22
E. Create New Farm and Ranch Risk Management ("FARRM") Accounts	tyba 12/31/00	---	---	-7	-147	-204	-173	-142	-110	-48	-23	-23	-531	-877
Total of Small Business Tax Relief Provisions		**---**	**-1,035**	**-1,895**	**-1,377**	**-957**	**-173**	**-1,204**	**-623**	**-214**	**874**	**225**	**-5,440**	**-6,381**
Title VII. Estate and Gift Tax Relief Provisions														
A. Reduce Estate, Gift, and Generation-Skipping Transfer Taxes: beginning in 2001, repeal the 5% "bubble" (which phases out the lower rates), and repeal rates in excess of 50%; beginning in 2004, convert the unified credit into a true exemption; in 2007, increase $1 million exemption amount to $1.5 million	dda & gma 12/31/00	---	---	---	-2,076	-2,190	-2,236	-6,385	-6,872	-7,337	-15,227	-16,262	-6,502	-58,585

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
B. Expand Estate Tax Rule for Conservation Easements - increase the 25-mile limit to 50 miles and clarify that the date for determining easement compliance	dda 12/31/97 & dda 12/31/99	---	---	-9	-12	-17	-18	-18	-19	-20	-22	-23	-56	-158
C. Increase the Annual Gift Tax Exclusion - increase from $10,000 to $12,000 for 2001, $13,500 for 2002, $15,000 for 2003, $16,500 for 2004, $18,000 for 2005, and $20,000 for 2006 and thereafter	gma 12/31/00	---	---	---	-74	-137	-281	-389	-516	-705	-794	-903	-492	-3,799
D. Simplification of Generation-Skipping Transfer Tax Rules	generally DOE	---	-3	-4	-5	-6	-6	-6	-6	-6	-6	-6	-24	-54
Total of Estate and Gift Tax Relief Provisions ……………………………………….		**---**	**-3**	**-13**	**-2,167**	**-2,350**	**-2,541**	**-6,798**	**-7,413**	**-8,068**	**-16,049**	**-17,194**	**-7,074**	**-62,596**
Title VIII. Tax-Exempt Organization Provisions														
A. Provide a Tax Exemption for Organizations Created by a State to Provide Property and Casualty Insurance Coverage for Property for Which Such Coverage is Otherwise Unavailable	tyba 12/31/99	---	-2	-4	-4	-4	-5	-5	-6	-7	-8	-8	-19	-53
B. Modify Section 512(b)(13) - exempt income received by a tax-exempt organization from certain subsidiaries when fair market value pricing is used, excess of fair market value subject to UBIT and 20% penalty, and extension of transition relief for certain binding contracts	DOE & pra 12/31/99	---	-7	-9	-11	-11	-11	-11	-12	-12	-12	-13	-49	-110
C. Simplify Lobbying Expenditure Limitations	tyba 12/31/99	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-1
D. Tax-Free Withdrawals from IRAs for Charitable Donations After Age 70.5	tyba 12/31/00	---	---	-172	-267	-270	-273	-276	-279	-282	-285	-288	-982	-2,393
E. Provide Exclusion for Mileage Reimbursements by Public Charities (not in excess of standard business mileage rate)	tyba 12/31/99	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-1	-2
F. Charitable Deduction for Certain Expenses in Support of Native Alaskan Subsistence Whaling	tyba 12/31/99	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-1	-3
G. Allow Charitable Donations to Certain Low Income Schools to be Made on or Before the Deadline for Filing a Federal Income Tax Return (not including extensions)	tyba 12/31/99	---	-4	-30	-32	-33	-35	-37	-38	-40	-42	-44	-134	-335
H. Allow Taxpayers Who Do Not Itemize to Deduct up to $50 ($100 joint) of Their Charitable Contributions in Addition to Their Standard Deduction for 2000 and and 2001	tyba 12/31/99	---	-98	-655	-558	---	---	---	---	---	---	---	-1,311	-1,311
I. Increase AGI Percentage Limits for Deduction of Charitable Donations by 2% Annually Until the 50%-of-AGI Limit Reaches 60% and the 30%-of-AGI Limit Reaches 40%, Then by an Additional 10% in 2007 for Both Limits	tyba 12/31/01	---	---	---	-122	-275	-317	-326	-333	-614	-842	-882	-714	-3,711
J. Increase the Limit for Deduction for Corporate Charitable Donations by 2% Annually Until the 10% Limit Reaches 20%	tyba 12/31/01	---	---	---	-15	-34	-40	-41	-42	-43	-45	-47	-89	-307
K. Allow Private Foundations to Increase Their Holding in Publicly Traded Voting Stock of a Corporation Received by Bequest from 20% to: 40% in 2007, and 49% in 2008 and thereafter	dda 12/31/06	---	---	---	---	---	---	---	---	---	-627	-845	---	-1,472
Total of Tax-Exempt Organization Provisions ……………………………………….		**---**	**-111**	**-870**	**-1,009**	**-627**	**-681**	**-696**	**-710**	**-998**	**-1,861**	**-2,127**	**-3,300**	**-9,698**

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
Title IX. International Tax Relief Provisions														
A. Allocation Interest Expense on Worldwide Basis	tyba 12/31/03	---	---	---	---	---	-820	-2,190	-2,278	-2,369	-2,464	-2,562	-820	-12,683
B. Simplify and Apply Look-Through Treatment for Dividends of 10/50 Companies and Separate Basket Excess Credit Carryovers	tyba 12/31/02	---	---	---	---	-221	-255	-63	-32	-22	-17	-12	-476	-622
C. Exception from Subpart F Treatment for Certain Pipeline Transportation and Electricity Transmission Income	tyba 12/31/02	---	---	---	---	-4	-13	-15	-17	-20	-23	-25	-17	-117
D. Prohibit Disclosure of Advance Pricing Agreements (APAs) and Related Information; Require the IRS to Submit to Congress an Annual Report of Such Agreements; APA User Fee	DOE	*Negligible Revenue Effect*												
E. Exempt from the 7.5% Air Passenger Ticket Tax Frequent Flier Miles to Persons With Foreign Addresses	1/1/00	---	-15	-15	-17	-21	-24	-26	-28	-29	-30	-32	-92	-238
F. Repeal Limits on Foreign Sales Corporation Tax Benefits for the Defense Products Industry	tyba 12/31/04	---	---	---	---	---	---	-56	-160	-173	-194	-215	---	-798
G. Repeal the 90% Limit on Foreign Tax Credits for the Individual and Corporate Alternative Minimum Tax............	tyba 12/31/04	---	---	---	---	---	---	-239	-446	-447	-440	-441	---	-2,014
Total of International Tax Relief Provisions ……………………………………………….		**---**	**-15**	**-15**	**-17**	**-246**	**-1,112**	**-2,589**	**-2,961**	**-3,060**	**-3,168**	**-3,287**	**-1,405**	**-16,472**
Title X. Housing and Real Estate Tax Relief Provisions														
A. Increase Low-Income Housing Per Capita Amount - increase from $1.25 by $0.10 annually for 2001 through 2005; allow $2 million small State minimum beginning in 2001	tyba 12/31/00	---	---	-4	-24	-71	-147	-251	-382	-528	-681	-836	-246	-2,924
B. Tax Credit for Renovating Historic Homes - 20% tax credit for renovating historic homes up to a maximum of $20,000; must live in the home for 5 years; limit to homes in historic districts with median income less than twice the State median income; include mortgage certificates	eia 12/31/99	---	-33	-132	-135	-139	-141	-143	-146	-149	-151	-154	-580	-1,323
C. Provisions Relating to REITs:														
1. Impose 10% vote or value test	tyba 12/31/00	---	---	2	8	8	8	9	9	9	10	10	26	73
2. Treatment of income and services provided by taxable REIT subsidiaries	tyba 12/31/00	---	---	60	158	53	23	-9	-45	-84	-127	-173	294	-145
3. Special foreclosure rule for health care REITs	tyba 12/31/00	*Negligible Revenue Effect*												
4. Conformity with RIC 90% distribution rules	tyba 12/31/00	---	---	1	1	1	1	1	1	1	1	1	3	5
5. Clarification of definition of independent contractors for REITs	tyba 12/31/00	*Negligible Revenue Effect*												
6. Modification of earnings and profits rules	da 12/31/00	---	---	-6	-3	-3	-3	-4	-4	-4	-4	-4	-16	-35
D. Accelerate 5-Year Phase in of Private Activity Bond Volume Cap	bia 12/31/00	---	---	-9	-36	-75	-117	-155	-183	-188	-177	-164	-237	-1,104
E. Provide a 15-Year Recovery Period for Depreciation of Leasehold Improvements	ima 12/31/02	---	---	---	---	-35	-123	-227	-325	-411	-445	-475	-158	-2,041
Total of Housing and Real Estate Tax Relief Provisions ……………………………….		**---**	**-33**	**-88**	**-31**	**-261**	**-499**	**-779**	**-1,075**	**-1,354**	**-1,574**	**-1,795**	**-914**	**-7,494**

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
Title XI. Miscellaneous Provisions														
A. Motor Fuels Taxes - repeal 4.3-cents-per-gallon fuel tax on railroads inland waterway carriers currently paid into the General Fund	10/1/00	---	---	-109	-117	-120	-122	-125	-128	-131	-134	-137	-469	-1,124
B. Tax Treatment of Alaska Native Settlement Trusts - exempt from tax distributions from Alaska Native Corporations to Alaska Native Settlement Trusts; special treatment of income earned; distributions to beneficiaries taxed as ordinary income	da & tyea 12/31/99	---	-9	-7	-7	-7	-7	-8	-8	-8	-8	-8	-38	-76
C. Corporate AMT - allow certain AMT credit carryovers to reduce minimum tax by 50% but not below regular tax	tyba 12/31/03	---	---	---	---	---	-552	-772	-671	-578	-499	-432	-552	-3,504
D. Allow 5-Year Carryback of Oil and Gas Net Operating Losses	lii tyba 12/31/98	---	-46	-28	-24	-21	-20	-20	-21	-21	-22	-23	-139	-246
E. Allow Deduction for Geological and Geophysical Expenses	eiopi tyba 12/31/99	---	-16	-25	-26	-27	-27	-28	-29	-29	-30	-31	-121	-267
F. Allow Deduction for "Delay Rental Payments"	pi tyba 12/31/99	---	-3	-4	-4	-4	-4	-4	-4	-3	-4	-5	-16	-39
G. Simplify the Active Trade or Business Requirement for Tax-Free Spin-Offs	da DOE	---	-3	-5	-5	-5	-5	-5	-5	-5	-5	-5	-23	-48
H. Increase Reforestation Credit Expenses to $25,000 Beginning in 2000; No Cap on Reforestation Expenses Qualifying for 7 Year Amortization for 2000 through 2003; Cap of $25,000 Beginning in 2004	epoii tyba 12/31/99	---	-5	-15	-22	-29	-34	-36	-38	-37	-33	-29	-104	-277
I. Add Inserts and Outserts to Arrow Excise Tax; Reduce Excise Tax Rate on "Broadhead" Arrow Points	fcqb 30da DOE	- *Negligible Revenue Effect* -												
J. Increase the Joint Committee on Taxation Refund Review Threshold from $1 Million to $2 Million	DOE	- *Negligible Revenue Effect* -												
K. Clarify the Definition of Rural Airport to Include Communities That Cannot be Reached by Road	tyba 12/31/99	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-1	-3
L. Allow Farmer Cooperatives to Pay Dividends on Capital Stock Without Reducing Patronage Dividends	tyba DOE	---	[7]	[7]	-1	-1	-1	-1	-2	-2	-3	-4	-3	-15
M. Repeal Prohibition on Life Companies Filing on a Consolidated Basis Until They Have Been Part of an Affiliated Group for at Least 5 Years	tyba 12/31/00	---	---	-42	-85	-86	-87	-88	-90	-92	-93	-94	-300	-757
N. Modifies Definition of Personal Holding Company and Groups Treating all Lending or Finance Businesses of a Controlled Corporate Group as a Single Corporation	tyba 12/31/99	---	-4	-10	-17	-24	-27	-28	-28	-28	-29	-30	-82	-227
O. 50% Tax Credit for Cost of Complying with Wheelchair Accessibility on Certain Inter-City Buses (sunset 12/31/11)	tyba 12/31/99	---	---	-1	-3	-3	-3	-3	-4	-4	-4	-4	-11	-29
P. Accelerate the 80% Meals Deduction for Persons Subject to the Hours of Service Requirements by 1 Year	DOE	---	---	---	---	---	---	---	---	-13	-13	---	---	-26
Q. Allow a Limited Number of Private Highway Projects to Qualify for Tax-Exempt-Facility Bond Financing	bia 12/31/99	---	---	---	-2	-5	-8	-11	-14	-18	-21	-24	-15	-102
R. Extend the DC First-Time Homebuyer Tax Credit 1 Year and Increase Phaseout for Joint Filers to $140,000 - $180,000	tyba 12/31/99	[7]	-11	-14	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	-25	-25

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
S. Expand the Zero-Percent Capital Gains Rate for DC Zone Assets to the Entire District of Columbia	DCZaoaa 12/31/99	---	-1	-3	-4	-6	-13	-15	-17	-18	-19	-21	-28	-118
T. Establish 7-Year Recovery Period for Natural Gas Gathering Lines	ppiso/a DOE	*Negligible Revenue Effect*												
U. Treat Small Seaplanes as General Aviation for Purposes of the Aviation Excise Taxes	tyba 12/31/99	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
Total of Miscellaneous Provisions ………………………………………………………		**---**	**-99**	**-264**	**-318**	**-339**	**-911**	**-1,145**	**-1,060**	**-988**	**-918**	**-848**	**-1,932**	**-6,894**
Title XII. Extension of Expired and Expiring Provisions														
A. Research Credit, and Increase in the Rates for the Alternative Incremental Research Credit by One-Percentage Point Per Step (permanent)	[12]	---	-1,657	-1,853	-2,226	-2,537	-2,766	-2,926	-3,072	-3,226	-3,387	-3,556	-11,038	-27,203
B. Exception from Subpart F for Active Financing Income (through 12/31/04)	tyba 1999	---	-187	-827	-992	-1,190	-1,369	-1,156	---	---	---	---	-4,565	-5,721
C. Suspension of 100% Net Income Limitation for Marginal Properties (through 12/31/04)	tyba 12/31/99	---	-23	-35	-36	-36	-37	-13	---	---	---	---	-167	-180
D. Work Opportunity Tax Credit (through 6/30/04)	wpoifibwa 6/30/99	---	-229	-321	-397	-430	-391	-254	-114	-40	-11	-2	-1,767	-2,188
E. Welfare-to-Work Tax Credit (through 6/30/04)	wpoifibwa 6/30/99	---	-49	-77	-101	-112	-105	-74	-37	-14	-4	-1	-445	-575
F. Extend and Modify Tax Credit for Electricity Produced from Wind and Closed-Loop Biomass Facilities (credit to include electricity produced from poultry waste and operators of such government owned facilities, landfill gas used to produce electricity, and non-closed-loop biomass (including production from such biomass at coal cofiring facilities) to the list of qualified resources under section 45 (through 6/30/04 generally, and through 12/31/02 for non-closed-loop biomass)	[13]	---	-33	-82	-124	-159	-186	-198	-203	-208	-213	-217	-585	-1,623
G. Alaska Exemption from Diesel Fuel and Kerosene Dyeing Rules (permanent)	DOE	---	---	---	---	---	[7]	-1	-1	-1	-1	-1	[7]	-3
H. Brownfields Environmental Remediation (through 6/30/04); Expand to all of the United States	eia 12/31/99	---	-1	-65	-160	-207	-240	-145	-27	10	23	30	-672	-782
Total of Extension of Expired and Expiring Provisions ………………………………		**---**	**-2,179**	**-3,260**	**-4,036**	**-4,671**	**-5,094**	**-4,767**	**-3,454**	**-3,479**	**-3,593**	**-3,747**	**-19,239**	**-38,275**
Title XIII. Revenue Offset Provisions														
A. Modify Foreign Tax Credit Carryover Rules - 1-year carryback of foreign tax credits and 7-year carryforward	tyba 12/31/99	---	87	562	502	468	437	406	279	263	259	257	2,056	3,520
B. Information Reporting on Cancellation of Indebtedness by Non-Bank Financial Institutions	coda 12/31/99	---	---	7	7	7	7	7	7	7	7	7	28	63
C. Increase to 15% (from 10%) Optional Withholding Rate for Nonperiodic Payments from Deferred Compensation Plans	dma 12/31/00	---	---	52	1	1	1	1	1	1	1	1	55	59
D. Extend IRS User Fees (through 9/30/09) [3]	9/30/03	---	---	---	---	---	50	53	56	59	61	64	50	343
E. Allow Employers to Transfer Excess Defined Benefit Plan Assets to a Special Account for Health Benefits of Retirees (through 9/30/09)	tmi tyba 12/31/00	---	---	19	38	39	40	41	42	42	43	44	136	348
F. Clarify the Tax Treatment of Income and Losses from Derivatives	DOE	---	[1]	1	1	1	1	1	1	1	1	1	4	9

Provision	Effective	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	1999-04	1999-09
G. Loophole Closers														
1. Limit use of non-accrual experience method of accounting to amounts to be received for the performance of qualified professional services	tyea DOE	---	77	60	33	28	10	12	14	16	18	20	208	288
2. Impose limitation on pre-funding of certain employee benefits	cmo/a 6/9/99	22	93	141	147	149	140	129	118	105	90	74	693	1,209
3. Repeal installment method for most accrual basis taxpayers; adjust pledge rules	iso/a DOE	---	477	677	406	257	72	8	21	35	48	62	1,889	2,063
4. Prevent the conversion of ordinary income or short-term capital gains into income eligible for long-term capital gain rates	teio/a 7/12/99	---	15	45	47	49	51	54	58	62	66	70	207	517
5. Deny deduction and impose excise tax with respect to charitable split-dollar life insurance arrangements.........	[14]	- *Negligible Revenue Effect* -												
6. Modify estimated tax rules for closely-owned REIT dividends	epdo/a 9/15/99	---	40	1	1	1	1	1	1	1	1	1	45	52
7. Prohibited allocation of stock in an ESOP of a subchapter S corporation	[15]	---	[16]	[16]	[16]	[16]	[16]	[16]	[16]	[16]	[16]	[16]	17	47
8. Modify anti-abuse rules related to assumption of liabilities	aolo/a 7/15/99	---	2	4	5	5	5	5	5	5	5	5	21	46
9. Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions	to/a DOE	---	25	26	28	29	30	32	34	35	37	39	138	315
10. Modify treatment of closely-held REITs, with incubator REIT exception	tyea 7/14/99	---	2	5	5	5	6	6	6	6	7	7	23	55
11. Distributions by a partnership to a corporate partner of stock in another corporation	dma 7/14/99	---	6	11	10	10	9	9	9	9	9	8	46	90
Total of Revenue Offset Provisions ……………………………………………………….		**22**	**826**	**1,614**	**1,235**	**1,053**	**865**	**770**	**658**	**653**	**659**	**666**	**5,616**	**9,024**
Title XIV. Tax Technical Correction Provisions ……………………………………………….		**- *No Revenue Effect* -**												
NET TOTAL		**22**	**-4,139**	**-24,615**	**-39,400**	**-41,979**	**-45,357**	**-89,876**	**-114,676**	**-129,407**	**-145,746**	**-156,655**	**-155,472**	**-791,848**
ADDENDUM: TAX CUT TARGET ………………………………………………………………….		**---**	**-14,000**	**-7,800**	**-53,500**	**-31,800**	**-49,200**	**-62,600**	**-109,300**	**-135,800**	**-150,700**	**-177,200**	**-156,300**	**-791,900**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[Legend and Footnotes for JCX-55-99 appear on the following page]

Legend and Footnotes for JCX-55-99:

Legend for "Effective" column:

aiii TRA'97 = as if included in the Taxpayer Relief Act of 1997
aolo/a = assumption of liabilities on or after
bia = bonds issued after
cmi = contributions made in
coda = cancellation of indebtedness after
cmo/a = contributions made on or after
da = distributions after
dda = decedents dying after
dma = distributions made after
DCZaoaa = DC Zone assets originally acquired after
DOE = date of enactment
eia = expenses incurred after
eiopi = expenses incurred or paid in
epdo/a = estimated payments due on or after
fcqb = first calendar quarter beginning at least
gma = gifts made after
ima = improvements made after
iso/a = installment sales on or after
lii = losses incurred in

lpo/a = labor performed on or after
noitta = notice of intent to terminate after
pateo/a = plan amendments taking effect on or after
pea = plans established after
pi = payments in
ppiso/a = property placed in service on or after
pra = payments received after
pyba = plan years beginning after
rma = requests made after
ta = transfers after
tdapma = transfers, distributions, and payments made after
teia = transactions entered into after
teio/a = transactions entered into on or after
tmi = transfers made in
to/a = transactions on or after
tyba = taxable years beginning after
tyea = taxable years ending after
wpoifibwa = wages paid or incurred for individuals beginning work after
yba = years beginning after

[1] Proposal includes interaction with other provisions in Provisions for Expanding Coverage.
[2] Proposal includes interaction with other provisions in Provisions for Individual Retirement Arrangements.
[3] Estimate provided by the Congressional Budget Office.
[4] Loss of less than $5 million.
[5] Effective for distributions from terminating plans that occur after the PBGC has adopted final regulations implementing provision.
[6] Directs the Secretary of the Treasury to modify rules through regulations.
[7] Loss of less than $500,000.
[8] Estimate considers interaction with HOPE and Lifetime Learning tax credits.
[9] The provision takes effect only if subsequent non-tax legislation specifically granting the Federal Home Loan Banks the authority to enter into these guarantees is enacted.
[10] Estimate assumes concurrent enactment of the above-the-line deduction for health and long-term care insurance (item 1. under Health Care Tax Relief Provisions).
[11] Effective for vaccine sales the date after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugate Streptococcus Pneumoniae vaccines to children.
[12] Extension of credit effective for expenses incurred after 6/30/99; increase in AIC rates effective for taxable years beginning after 6/30/99.
[13] For wind and closed-loop biomass, provision applies to production from facilities placed in service after 6/30/99 and before 7/1/04; for poultry waste and landfill gas, provision applies to production from facilities placed in service after 12/31/99 and before 7/1/04; for non-closed-loop biomass, provision applies to production after 12/31/99 from facilities placed in service before 1/1/03.
[14] Effective for transfers made after 2/8/99 and for premiums paid after the date of enactment.
[15] Effective with respect to ESOPs established on or after July 15,1999; in the case of an ESOP established by an S corporation before such date, the provision would apply to plan years beginning after 12/31/00.
[16] Gain of less than $10 million.

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the provisions of the bill as reported involve increased budget authority (outlays) for the refundable portion of certain tax credit changes in the bill. The estimated outlay effects are $11 million in 2000, $40 million in 2001, $227 million in 2002, $360 million in 2003, $373 million in 2004, $424 million in 2005, $1,576 million in 2006, $1,601 million in 2007, $1,598 million in 2008, and $1,594 million in 2009.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing income tax provisions (other than the tax rate and marriage penalty provisions) involve increased tax expenditures and the revenue-increasing income tax provisions (other than the foreign tax credit provision) involve reduced tax expenditures (see revenue table in Part III.A, above).

C. Consultation with the Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget office has [has not] submitted a statement on this bill.

[Insert CBO statement, if received]

IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the rollcall votes in the Committee's consideration of the bill.

Motion to report the bill

The bill was ordered favorably reported by a roll call vote of 13 yeas and 6 nays (13 yeas and 7 nays including 1 nay proxy) on July 21, 1999. The vote, with a quorum present, was as follows:

Yeas.--Senators Roth, Chafee, Hatch, Murkowski, Nickles, Gramm, Lott, Jeffords, Mack, Thompson, Breaux, and Kerrey.

Nays.--Senators Moynihan, Baucus, Rockefeller, Conrad, Graham, Bryan (proxy), and Robb.

Votes on other amendments

- A substitute amendment by Senator Gramm to reduce all marginal income tax rates by 10 percent, eliminate the marriage tax penalty, repeal estate and gift taxes, and provide 100 percent deduction for self-employed health insurance was defeated by a rollcall vote of 7 yeas and 13 nays. The vote was as follows:

Yeas.--Senator Hatch, Murkowski, Nickles, Gramm, Lott, Mack, and Thompson.

Nays.--Senators Roth, Chafee, Grassley, Jeffords, Moynihan, Baucus, Rockefeller, Breaux, Conrad, Graham, Bryan, Kerry (proxy) and Robb.

- An amendment by Senators Baucus and Conrad to reduce the tax cuts in the bill by an amount sufficient to allow one-third of the on budget surplus to be dedicated to Medicare was defeated by a rollcall vote of 7 yeas and 9 nays. The vote was as follows:

Yeas.--Senators Moynihan, Baucus, Rockefeller, Conrad, Graham, Bryan, and Robb.

Nays.--Senators Roth, Chafee, Grassley, Nickles, Gramm, Lott, Jeffords, Mack, and Breaux.

- An amendment by Senators Graham and Robb to delay the effective date of the tax cut bill until after enactment of legislation to extend the solvency of the Social Security Trust Fund through 2075 and the Medicare Part A program through 2027 was defeated by a roll call vote of 9 yeas and 11 nays. The vote was as follows:

Yeas.--Senators Moynihan, Baucus, Rockefeller, Breaux, Conrad (proxy), Graham, Bryan, Kerrey, and Robb (proxy).

Nays.--Senators Roth, Chafee (proxy), Grassley, Hatch, Murkowski, Nickles, Gramm (proxy), Lott (proxy), Jeffords, Mack (proxy), and Thompson (proxy).

- An amendment by Senator Grassley to expand Code section 45 to include open-loop biomass and co-firing was adopted by a roll call vote of 14 yeas and 6 nays. The vote was as follows:

Yeas.–Senators Grassley, Hatch, Murkowski; Lott (proxy), Jeffords, Mack, Baucus, Rockefeller, Breaux (proxy), Conrad, Graham, Bryan, Kerrey, and Robb.

Nays.–Senators Roth, Chafee (proxy), Nickles, Gramm, Thompson, and Moynihan.

- An amendment by Senator Conrad to provide a tax credit for information technology training expenses and to reduce the tax reductions pro rata in the bill (except for extenders and paid-for items) was defeated by a roll call vote of 9 yeas and 11 nays. The vote was as follows:

Yeas.–Senators Moynihan, Baucus, Rockefeller, Breaux, Conrad, Graham, Bryan, Kerrey (proxy), and Robb.

Nays.–Senators Roth, Chafee, Grassley, Hatch, Murkowski, Nickles, Gramm, Lott, Jeffords, Mack (proxy), and Thompson (proxy).

- An amendment by Senator Nickles to expand the 15-percent individual income tax bracket was defeated by a rollcall vote of 8 yeas and 12 nays. The vote was as follows:

Yeas.–Senators Grassley (proxy), Hatch, Murkowski, Nickles, Gramm, Lott, Mack, and Thompson.

Nays.–Senators Roth, Chafee, Jeffords, Moynihan, Baucus, Rockefeller, Breaux, Conrad, Graham, Bryan (proxy), Kerrey, and Robb.

V. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as reported.

<u>**Impact on individuals and businesses**</u>

Title I of the bill provides a reduction in the 15-percent individual income tax rate to 14 percent in 2001, and increases the width of this bracket beginning in 2005.

Title II of the bill provides family tax relief: (1) election for married couples to calculate combined tax as individuals on a combined return; (2) marriage penalty relief for the earned income credit; (3) expand the exclusion for certain foster care payments; (4) increase and expand the dependent care tax credit; (5) new tax credit for employer-provided child care facilities; and (6) permanent extension of the allowance of nonrefundable personal tax credits against the individual minimum tax and allow personal exemptions against the AMT.

Title III of the bill provides retirement savings tax relief: (1) increase the annual contribution limit for all IRAs; (2) increase the AGI limitation for contributions to a deductible IRA; (3) eliminate the AGI limitation for contributions to a Roth IRA; (4) increase the AGI limitation to $1 million for conversions of an IRA to a Roth IRA; (5) new tax credit for matching contributions by financial institutions to Individual Development Accounts; (6) certain coins not treated as collectibles for IRAs; and (7) various provisions expanding pension coverage, enhancing pension fairness for women, increasing pension portability, strengthening pension security and enforcement, encouraging retirement education, and reducing pension regulatory burdens.

Title IV of the bill provides tax relief for education: (1) increase student loan interest deduction income limits and repeal the 60-month rule; (2) exclusion for distributions from State-sponsored tuition plans and tax deferral for private plans, as well as tax-free education withdrawals from prepaid plans and education savings plans as long as they are not used for the same expenses for which HOPE or Lifetime Learning tax credits are claimed; (3) exclusion for awards under the National Health Corps Scholarships and F. Edward Hebert Armed Forces Health Professions Scholarships; (4) permanent extension of the exclusion for employer-provided education assistance (including graduate education); (5) increase in the school construction small issue arbitrage rebate exception; (6) issuance of tax-exempt private activity bonds for qualified education facilities; and (7) Federal Home Loan Bank guarantee of certain school bonds (contingent on subsequent legislation).

Title V of the bill includes certain health care tax provisions: (1) an above-the-line deduction for a portion of certain health insurance costs where the individual is not eligible to participate in an employer-subsidized health plan; (2) an above-the-line deduction for certain long-term care insurance costs; (3) allow long-term care insurance to be offered as part of cafeteria plans; (4) an additional personal exemption for caretakers of elderly family members; (5) add Streptococcus Pneumoniae vaccine to the list of taxable vaccines; and (6) reduce the vaccine excise tax on all taxable vaccines to 25 cents per dose beginning in 2005.

Title VI of the bill provides small business tax relief: (1) accelerate the 100-percent deduction for self-employed health insurance to 2000; (2) increase section 179 expensing to $30,000 in 2000; (3) repeal of the FUTA 0.2 surtax on January 1, 2005; (4) coordination of farmer income averaging and the alternative minimum tax; and (5) permit new Farm and Ranch Risk Management Accounts.

Title VII of the bill provides estate and gift tax relief: (1) reduce estate and gift and generation-skipping transfer (GST) taxes; (2) expand estate tax rule for conservation easements; (3) increase the annual gift tax exclusion to $20,000; and (4) simplify the GST rules.

Title VIII of the bill provides tax modifications relating to tax-exempt organizations: (1) tax exemption for organizations created by a State to provide property and casualty insurance coverage for property for which such coverage is otherwise unavailable; (2) modify Code section 512(b)(13) relating to exempt income from certain subsidiaries; (3) simplify lobbying expenditure limitations; (4) tax-free withdrawals from IRAs for charitable donations after age 70½; (5) exclusion for mileage reimbursements by public charities (not in excess of standard business mileage rate); (6) charitable deduction for certain expenses in support of native Alaskan subsistence whaling; (7) allow charitable donations to certain low-income schools to be made on or before April 15; (8) allow non-itemizers a deduction of $50 ($100 for joint returns) for 2000 and 2001 in addition to regular standard deduction; (9) increase in percentage limits for individual and corporate charitable contributions deductions; and (10) allow private foundations to increase their holdings in publicly traded voting stock of a corporation received by bequest from 20 percent to 40 percent in 2007 and 49 percent in 2008 and thereafter.

Title IX of the bill provides tax relief for certain international businesses and transactions: (1) allocate interest expense on worldwide basis; (2) simplify and apply look-through rules for dividends from noncontrolled section 902 corporations and separate excess credit carryovers; (3) exception from subpart F treatment for certain pipeline transportation and electricity transmission income; (4) prohibit disclosure of Advance Pricing Agreements (APAs) and related information and impose an APA user fee; (5) exempt certain sales of frequent flyer and similar reduced-fare air transportation rights from air passenger excise tax for persons with foreign addresses; (6) repeal the 90-percent limit on foreign tax credits for the individual and corporate AMT; and (7) repeal limits on Foreign Sales Corporation tax benefits for the defense products industry.

Title X of the bill provides housing and real estate tax relief: (1) increase in the low-income housing tax credit per capita amount; (2) tax credit for renovating historic homes; (3) certain revisions relating to real estate investment trusts (REITs); (4) increase State volume limits on tax-exempt private activity bonds; and (5) 15-year recovery period for depreciation of certain leasehold improvements.

Title XI of the bill provides certain miscellaneous tax provisions: (1) repeal of 4.3-cents-per-gallon General Fund excise tax for rail and inland waterway fuels on October 1, 2000; (2) exemption for distributions from Alaska Native Corporations to Alaska Native Settlement Trusts; (3) allow corporate AMT credit carryovers to reduce AMT by 50 percent (but not below regular tax); (4) 5-year carryback of oil and gas net operating losses; (5) current deduction for geological and geographical expenses; (6) deduction for certain oil and gas "delay rental payments;" (7) simplify the active trade or business requirement for tax-free spin-offs; (8) increase maximum amount of reforestation expenses eligible for amortization and tax credit; (9) modify excise tax on arrow components and accessories (add "inserts and outserts" to the tax and reduce the tax rate on "broadhead" arrow points); (10) allow farmer cooperatives to pay dividends on capital stock without reducing patronage dividends; (11) repeal the 5-year limitation on treating life insurance companies as includible corporations that may file a consolidated tax return with an affiliated group including non-life insurance companies; (12) modify personal holding company provisions to treat all lending or finance businesses of a controlled group of corporations as a single corporation for purposes of an active business safe harbor and modify the definition of lending or finance business; (13) new 50-percent tax credit for costs of complying with wheelchair accessibility requirements on certain inter-city buses for 2000-2011; (14) clarify definition of rural airport for purposes of the air passenger ticket tax; (15) accelerate the scheduled increase in the deduction for meals for individuals subject to Federal hours of service rules so that the deduction is 80 percent in 2007 and thereafter; (16) allow private activity tax-exempt bonds to be issued to finance the 15 pilot projects eligible for certain innovative financing assistance under the Transportation Equity Act for the 21st Century, limited to a maximum of $15 billion of such bonds; (17) 7-year cost recovery for natural gas gathering lines; (18) one-year extension of the D.C. first-time homebuyer tax credit, with an increase in the income phaseout for joint filers; (19) expand the D.C. zero-rate capital gains to the whole District of Columbia; (20) treat certain seaplanes as general aviation for purposes of the aviation excise taxes; and (21) increase the Joint Committee on Taxation refund review threshold from $1 million to $2 million.

Title XII of the bill provides extensions of certain expired or expiring tax provisions: (1) permanent extension of the research credit, with an increase in the rates for the alternative incremental research credit; (2) exception from subpart F for active financing income (through December 31, 2004); (3) suspension of 100-percent-of-net-income limitation on percentage depletion for marginal oil and gas wells (through December 31, 2004); (4) work opportunity tax credit (through June 30, 2004); (5) welfare-to-work tax credit (through June 30, 2004); (6) tax credit for electricity produced by wind and closed-loop biomass facilities (through June 30, 2004), and to include electricity produced from poultry waste, other biomass, landfill gas, and co-firing; (7) permanent extension of Alaskan exemption from diesel dyeing requirements; and (8) expensing of environmental remediation ("brownfields") costs (through June 30, 2004), to include all of the United States.

Title XIII of the bill provides certain revenue-offset provisions: (1) one-year carryback of foreign tax credits and 7-year carryforward; (2) information reporting on cancellation of indebtedness by non-bank financial institutions; (3) increase (from 10 percent to 15 percent) in optional withholding for nonperiodic payments from deferred compensation plans; (4) extension of IRS user fees (through September 30, 2009); (5) transfer of excess defined benefit plans assets for retiree health benefits; (6) clarify tax treatment of income and loss on derivatives; (7) limit use of non-accrual experience method of accounting to amounts to be received for the performance of qualified professional services; (8) limitation on prefunding of certain employee benefits; (9) repeal installment method for most accrual basis taxpayers and adjust pledge rules; (10) limit conversation of ordinary income or short-term capital gain to long-term capital gain from constructive ownership transactions; (11) deny deduction and impose excise tax with respect to charitable split-dollar life insurance arrangements; (12) modify estimated tax rules for closely-held REITS; (13) prohibited allocation of stock in an ESOP of a subchapter S corporation; (14) modify anti-abuse rules related to assumption of liabilities; (15) require consistent treatment and provide basis allocation rules for transfer of intangibles in certain nonrecognition transactions; (16) modify treatment of closely-held REITs; and (17) distributions by a partnership to a corporate partner of stock in another corporation.

Title XIV provides necessary technical corrections to recent tax legislation.

Finally, Title XV relates to compliance with the Congressional budget rules.

The revenue-offset provisions will increase the tax burden on the affected taxpayers. The other provisions generally will reduce the tax burdens on individuals, small businesses, estates, and others.

Impact on personal privacy and paperwork

The bill should not have any adverse impact on personal privacy.

New tax credits under the bill (tax credit for employer-provided child care facilities, tax credit for new Individual Development Accounts, tax credit for renovating historic homes, and tax credit for costs of complying with wheelchair accessibility requirements on certain inter-city buses for 2000-2011) will involve some increased paperwork for affected taxpayers and the Internal Revenue Service.

Also, new above-the-line deductions for individual taxpayers (certain health insurance and long-term care insurance expenses, and a limited amount of charitable donations for 2000 and 2001) will involve some increased paperwork for affected taxpayers and the Internal Revenue Service.

In addition, a new exemption from the excise tax on rights to free and reduced-fare air transportation for persons with foreign addresses will require additional paperwork for affected taxpayers and the Internal Revenue Service.

For further discussion of the impact of certain provisions of the bill on tax complexity, see V.C., below.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Act of 1995 (P.L. 104-4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector: (1) add certain vaccines against streptococcus pneumoniae to the list of taxable vaccines; (2) impose 10-percent vote or value test for REITs; (3) treatment of income and services provided by taxable REIT subsidiaries; (4) one-year carryback of foreign tax credits and 7-year carryforward; (5) information reporting on cancellation of indebtedness by non-bank financial institutions; (6) limit use of non-accrual experience method of accounting to amounts to be received for the performance of qualified professional services; (7) impose limitation on prefunding of certain employee benefits; (8) repeal installment method for most accrual basis taxpayers; (9) prevent the conversion of ordinary income or shot-term capital gains into income eligible for long-term capital gain rates; (10) deny deduction and impose excise tax with respect to charitable split dollar life insurance arrangements; (11) modify estimated tax rules for closely-held REITs; (12) prohibited allocation of stock in an ESOP of a subchapter S corporation; (13) modify anti-abuse rules related to assumption of liabilities; (14) require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions; (15) modify treatment of closely held REITs, with incubator REIT exception; and (16) distributions by a partnership to a corporate partner of stock in another corporation.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effect of the provision. Benefits from the provisions include improved administration of the Federal tax laws and a more accurate measurement of income for Federal income tax purposes.

The provision that adds Streptococcus Pneumoniae vaccine to the list of taxable vaccines for purposes of the vaccine excise tax imposes a Federal intergovernmental mandate on State, local, and tribal governments. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with this Federal intergovernmental mandate will not exceed $50,000,000 in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year. The Committee intends that this Federal intergovernmental mandate be unfunded because the net revenues from the Federal vaccine excise tax are used to finance the Federal Vaccine Injury Compensation Trust Fund. Since the excise tax is imposed on the private sector and on State, local, and tribal governments, they do not affect the competitive balance between such governments and the private sector.

C. Complexity Analysis

The following tax complexity analysis is provided pursuant to section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998, which requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service ("IRS") and the Treasury Department) to provide a complexity analysis of tax legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or a Conference Report containing tax provisions. The complexity analysis is required to report on the complexity and administrative issues raised by provisions that directly or indirectly amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided, along with an estimate of the number and the type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS regarding each of the provisions included in the complexity analysis, including a discussion of the likely effect on IRS forms and any expected impact on the IRS.

1. Reduce the 15 percent income tax rate to 14 percent in 2001 and thereafter (sec. 101 of the bill)

Summary description of provision

The provision reduces the lowest individual regular income tax rate from 15 percent to 14 percent. The rate reduction does not apply to the capital gains tax rates.

Number of affected taxpayers

It is estimated that the reduction of the regular income tax rates will affect approximately 98 million individual income tax returns each year, of which approximately 80 million have income of less than $75,000.

Discussion

It is not anticipated that individuals will need to keep additional records due to this provision. The information necessary to implement the provision will be readily available to taxpayers (in the form of new tax tables and tax rate schedules). The rate reduction should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision.

Because the provision does not include a corresponding reduction in the individual alternative minimum tax rates, the provision could result in some individual taxpayers having to calculate their tax liability under the alternative minimum tax (AMT). While other provisions in this bill reduce the number of individual taxpayers subject to the alternative minimum tax (e.g., by allowing individuals to offset the entire regular tax liability by the nonrefundable personal credits and allowing the deduction for personal exemptions in computing AMT), some taxpayers may still be required to make additional calculations under the AMT rules. For those individuals, the provision could result in some increased complexity (and possibly an increase in tax preparation costs).

2. Increase the width of the 14 percent bracket in 2005 (sec. 102 of the bill)

Summary description of provision

The provision increases the size of the otherwise applicable 14-percent rate bracket by $2,000 ($4,000 for married couples filing a joint return) beginning in 2005. The size of the otherwise applicable 14-percent rate bracket would then be increased by a total of $2,500 ($5,000 for married couples filing a joint return) beginning in 2007.

Number of affected taxpayers

It is estimated that the reduction of the regular income tax rates will affect approximately 36 million individual income tax returns.

Discussion

The effects of this provision are similar to that of the reduced rate. Thus, it is not anticipated that individuals will need to keep additional records due to this provision. The information necessary to implement the provision will be readily available to taxpayers (in the form of new tax tables and tax rate schedules). The rate reduction should not result in an increase in disputes with the IRS, nor will regulatory guidance be necessary to implement this provision. In addition, the provision should not increase individuals' tax preparation costs unless the individual is required to calculate its tax liability under the AMT rules as a result of this provision.

3. Election to calculate combined tax as individuals for a married couple filing a joint return (sec. 201 of the bill)

Summary description of provision

Under the provision, married taxpayers 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 is calculated by applying the tax rates for single individuals to the separate taxable incomes.

Number of affected taxpayers

It is estimated that this provision will affect approximately 19 million individual income tax returns.

Discussion

In order to for married individuals to file separately under the provision, they will have to allocate to each spouse items of income or loss, deductions, and exemptions. The provision may result in an increase in disputes with the IRS, because the proper allocation of such items may be unclear. It is anticipated that regulatory guidance will be necessary to implement the provision, e.g., to address allocation issues. The provision includes an authorization to the Secretary to prescribe such regulations as the Secretary deems necessary or appropriate to carry out the provision. New forms and instructions will be needed to implement the provision. Taxpayers who utilize the separate filing option will need to maintain records to demonstrate that items of income, loss, etc. were properly allocated under the provision. It is expected that, in most cases, taxpayers will have such records for other purposes (e.g., records showing the ownership interest of each spouse in property).

The provision will add complexity for taxpayers because, in order to take advantage of the proposal, taxpayers will have to compute their tax liability in two different ways. Some States offer a similar option; in those States, taxpayers may already be calculating tax liability in a manner similar to that provided under the proposal. In such cases, the complexity added by the proposal may depend on the extent to which the State-law rules vary from the Federal rules. Because of the additional calculations under the provision, the provision may increase individuals' tax preparation costs.

4. Allow nonrefundable credits to offset regular tax liability and allow personal exemptions against AMT (sec. 206 of the bill)

Summary description of proposal

The provision allows the nonrefundable personal credits to offset the entire regular tax (without regard to the minimum tax), and also to allow the deduction for personal exemptions in computing the minimum tax.

Number of affected taxpayers

It is estimated that the minimum tax provisions will affect approximately 13 million individual income tax returns.

Discussion

It is not anticipated that individuals or small business will need to keep additional records due to this provision. It is estimated that five million people will no longer have to make the minimum tax computations and file the minimum tax form in filing their individual income tax returns. As a result, the provision is expected to result in a decrease in disputes with the IRS, and a decrease tax return preparation costs. It is not anticipated that regulatory guidance will be needed to implement this provision.

5. Increase in IRA contribution limit (sec. 301 of the bill)

Summary description of provision

The provision increases the $2,000 maximum IRA contribution limit to $3,000 in 2001, $4,000 in 2002, and $5,000 in 2003. Thereafter, the contribution limit is indexed in $100 increments.

Number of affected taxpayers

It is estimated that the provision will affect 15 million individual tax returns.

Discussion

It is not anticipated that individuals will need to keep additional records due to the provision. It is not anticipated that the provision will result in increased disputes with the IRS. It is not anticipated that the provision will increase tax return preparation costs. Regulatory guidance will not be needed to implement the provision; however, the Internal Revenue Service will need to publish the contribution limit as increased for inflation.

6. Accelerate 100-percent self-employed health insurance deduction (sec. 601 of the bill)

Summary description of provision

The provision accelerates the increase in the deduction for health insurance expenses of self-employed individuals so that the deduction is 100 percent in years beginning after December 31, 1999.

Number of affected taxpayers

It is estimated that the provision will affect three million small businesses.

Discussion

It is not anticipated that individuals or small businesses will need to keep additional records due to the provision. It is not anticipated that the provision will result in an increase in disputes with the IRS, or increase tax return preparation costs. It is not anticipated that regulatory guidance will be needed to implement the provision. Accelerating the 100-percent deduction may simplify the preparation of tax returns for self-employed individuals, because they will no longer need to keep track of the percent of health insurance expenses that are deductible, and will need to perform one less calculation.

7. Repeal of the temporary federal unemployment "FUTA" surtax (sec. 803 of the bill)

Summary description of provision

Under present law, in addition to the regular FUTA tax of 0.6 percent of taxable wages, a temporary surtax of 0.2 percent of taxable wages applies through 2007. The provision repeals the temporary FUTA surtax after December 31, 2004.

Number of affected taxpayers

It is estimated that the repeal of the FUTA surtax will affect over six million small businesses.

Discussion

It is not anticipated that small businesses will need to keep additional records due to this provision, nor is it anticipated that this provision will result in an increase in disputes with the IRS. Additional regulatory guidance should not be necessary to implement this provision. The provision should not increase the tax preparation cost for small businesses.

8. Allow non-itemizers to deduct charitable contributions for 2000 and 2001 (sec. 808 of the bill)

Summary description of provision

The provision allows taxpayers who do not itemize their deductions to claim an above-the-line deduction for charitable contributions for years 2000 and 2001. The deduction is limited to $50 for single taxpayers and $100 for married taxpayers filing a joint return.

Number of affected taxpayers

It is estimated that the provision will affect approximately 36 million individual tax returns, of which approximately 33 million have incomes less than $75,000.

Discussion

Individuals who do not itemize their deductions will need to keep additional records (e.g., canceled checks, a receipt from the donee organization, or other reliable written records) in order to prove that a contribution was made to a qualified charitable organization. The information necessary to implement the provision should be readily available to taxpayers (in the form of new tax return forms and instructions). The non-itemizer charitable contribution deduction is expected to require an addition line on the individual income tax return forms. The provision might result in a slight increase in disputes with the IRS for taxpayers who are unable to prove a claimed deduction (though the amount involved is not significant). Additional regulatory guidance should not be necessary to implement this provision. Any increase in the tax preparation costs should be negligible.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).