

**DESCRIPTION OF MODIFIED CHAIRMAN'S MARK
RELATING TO EXPIRING TAX PROVISIONS**

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

on October 20, 1999

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 19, 1999

JCX-73-99

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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the revised Chairman's Mark relating to expiring tax provisions scheduled for markup in the Senate Committee on Finance on October 20, 1999.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Modified Chairman's Mark Relating to Expiring Tax Provisions* (JCX-73-99), October 19, 1999.

I. EXTENSION OF EXPIRED AND EXPIRING PROVISIONS

A. Extend Minimum Tax Relief for Individuals

Present Law

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) \$45,000 in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 in the case of other unmarried individuals; and (3) \$22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). For taxable years beginning after 1998, the refundable child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

Description of Proposal

The proposal would extend the provision that allows the nonrefundable personal credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax liability exceeds the tentative minimum tax) to taxable years beginning in 1999 and 2000.

Under the proposal, the provision that reduces the refundable child credit by the amount of an individual's minimum tax would not apply to taxable years beginning before January 1, 2001.

Effective Date

The proposal would be effective for taxable years beginning in 1999 and 2000.

B. Extend Exclusion for Employer-Provided Educational Assistance

Present Law

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

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

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

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.² 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

² These rules also apply in the event that section 127 expires and is not reinstated.

minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.³

Description of Proposal

The proposal would reinstate the exclusion for employer-provided educational experience for graduate-level courses, and extend the exclusion, as applied to both undergraduate and graduate-level courses through 2000.

Effective Date

The proposal would be effective with respect to undergraduate courses beginning after May 31, 2000, and before January 1, 2001. The proposal would be effective with respect to graduate-level courses beginning after December 31, 1999, and before January 1, 2001.

C. Extend Research and Experimentation Credit and Increase in the Rates for the Alternative Incremental Research Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1999.

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

³ 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.

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.⁴

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

⁴ A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-based percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-based percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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”).⁵

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component.

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. For purposes of the credit, the term “United States” includes the 50 States and the District of Columbia, but not possessions. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

⁵ Under a special rule, 75 percent of amounts paid or incurred by a taxpayer to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under sec. 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

The research tax credit would be extended for 18 months, that is, for the period July 1, 1999 through December 31, 2000.

In addition, the credit rate applicable under the alternative incremental credit would be increased by one percentage point per step, that is, from 1.65 percent to 2.65 percent when a taxpayer's current-year research expenses exceed a base amount of 1 percent but do not exceed a base amount of 1.5 percent; from 2.2 percent to 3.2 percent when a taxpayer's current-year research expenses exceed a base amount of 1.5 percent but do not exceed a base amount of 2 percent; and from 2.75 percent to 3.75 percent when a taxpayer's current-year research expenses exceed a base amount of 2 percent.

The proposal also expands the definition of qualified research to include research undertaken in Puerto Rico and other possessions of the United States. However, any employee compensation or depreciation allowance claimed for computation of the research credit could not also be claimed for the purpose of any credit allowable under sec. 30A ("Puerto Rico economic activity credit") or under sec. 936 ("Puerto Rico and possession tax credit").

Effective Date

Extension of the research credit would be effective for qualified research expenditures paid or incurred beginning after June 30, 1999. The increase in the credit rate under the alternative incremental credit would be effective for taxable years beginning after June 30, 1999. The expansion of qualified research to include research undertaken in any possession of the United States would be effective for qualified research expenditures paid or incurred beginning after June 30, 1999.

D. Extend Exceptions under Subpart F for Active Financing Income

Present Law

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, foreign personal holding company income and insurance income. In addition, 10-percent U.S. shareholders of a CFC are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities

transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income"). These exceptions are applicable only for taxable years beginning in 1999.⁶

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, 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

⁶ 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.

exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Description of Proposal

The proposal would extend for one year the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The proposal would be effective only for taxable years of foreign corporations beginning in 2000, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

E. Extend Suspension of Net Income Limitation on Percentage Depletion From Marginal Oil and Gas Wells

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100 percent of the net income from that property in any year (sec. 613(a)).

Special percentage depletion rules apply to oil and gas production from “marginal” properties (sec. 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit). Under one such special rule, the 100-percent-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

Description of Proposal

The proposal would extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2001.

Effective Date

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

F. Extend the Work Opportunity Tax Credit

Present Law

The work opportunity tax credit (“WOTC”) is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to a percentage of qualified wages. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 hours or more. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,200. The credit is only effective for wages paid or incurred to qualified individuals who began work for the employer before July 1, 1999.

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

Description of Proposal

The proposal would extend the WOTC for 18 months, so that the credit would be available for eligible individuals who begin work for an employer before January 1, 2001.

Effective Date

Generally, the proposal would be effective for wages paid or incurred to qualified individuals who begin work for the employer on or after July 1, 1999, and before January 1, 2001.

G. Extend the Welfare-To-Work Tax Credit

Present Law

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

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of this credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

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

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before June 30, 1999.

Description of Proposal

The proposal would extend the welfare-to-work credit for 18 months, so that the credit would be available for eligible individuals who begin work for an employer before January 1, 2001.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before January 1, 2001.

H. Extend and Modify Tax Credit for Electricity Produced by Wind and Closed-Loop Biomass Facilities

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified “closed-loop” biomass facilities (sec. 45).

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 28(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above \$25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one taxable year and carried forward 20 taxable years (sec. 39).

Description of Proposal

The present-law tax credit for electricity produced by wind and closed-loop biomass would be extended to include production from facilities placed in service after June 30, 1999, and before January 1, 2001. The present-law initial placed-in-service date (January 1, 1993) for closed-loop biomass facilities and definition of a closed-loop biomass facility would be modified to extend the credit to post-December 31, 1999, electricity production at existing facilities that are modified after December 31, 1992, to use closed-loop biomass (e.g., switchgrass) as a fuel co-fired with coal. Production at co-fired facilities would be eligible without regard to whether the modifications otherwise qualified the facility as having been newly placed in service under general income tax principles.

The proposal also would modify the tax credit to include electricity produced from poultry litter, for facilities placed in service after December 31, 1999, and before January 1, 2001. The credit for electricity produced from poultry litter would be available to the lessor/operator of a qualified facility that was owned by a governmental entity.

The credit would be expanded to include electricity produced from landfill gas by the owner of the landfill gas collection facility, for electricity produced from facilities placed in service after December 31, 1999, and before January 1, 2001.

Finally, the credit would be expanded to include electricity produced from certain other biomass (in addition to closed-loop biomass and poultry waste). This additional biomass would

include 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 would include 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 would not include unsegregated municipal solid waste or paper that commonly is recycled. In the case of this additional biomass, the credit would apply to electricity produced after December 31, 1999 from facilities that are placed in service before January 1, 2001 (including facilities placed in service before the date of enactment of this proposal). As with closed-loop biomass facilities, the credit would be allowed for electricity production attributable to this additional biomass produced at facilities that are co-fired with coal.

In the case of electricity produced from landfill gas or gas from other biomass eligible for a credit under Code section 29, the electricity production credit would be available only if no section 29 credits have been claimed in the past on production from the gas production facility and the owner of that facility irrevocably elects not to claim the section 29 credit with respect to any future production. Such an election attaches to the otherwise qualified gas production facility and is binding without regard to changes in ownership of the facility.

Effective Date

The proposal would be effective on the date of enactment.

I. Expand Brownfields Environmental Remediation

Present Law

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A “qualified contaminated site” generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called “brownfields”). Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (“EPA”) Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the

Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred in taxable year's ending before January 1, 2001.

Description of Proposal

The proposal would eliminate the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency other than sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

Effective Date

The proposal to expand the class of eligible sites would be effective for expenditures paid or incurred after December 31, 1999.

J. Temporary Increase in Amount of Rum Excise Tax that is Covered Over to Puerto Rico and the U.S. Virgin Islands

Present Law

A \$13.50 per proof gallon⁷ excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States (sec. 5001). The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of \$10.50 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands (sec. 7652). During the 5-year period ending on September 30, 1998, the amount covered over was \$11.30 per proof gallon. This temporary increase was enacted in 1993 as transitional relief accompanying a reduction in certain tax benefits for corporations operating in Puerto Rico and the Virgin Islands (sec. 936).

Amounts covered over to Puerto Rico and the Virgin Islands are deposited in the treasuries of the two possessions for use as those possessions determine.

Description of Proposal

⁷A proof gallon is a liquid gallon consisting of 50 percent alcohol.

The proposal would increase from \$10.50 to \$13.50 per proof gallon the amount of excise taxes collected on rum brought into the United States that is covered over to Puerto Rico and the U.S. Virgin Islands.

The proposal would provide that \$0.50 per proof gallon of the amount covered over to Puerto Rico will be transferred to the Puerto Rico Conservation Trust, a private, non-profit section 501(c)(3) organization operating in Puerto Rico.

Effective Date

The proposal would be effective for excise taxes collected on rum imported or brought into the United States after June 30, 1999 and before January 1, 2001.

K. Delay Requirement that Registered Motor Fuels Terminals Offer Dyed Fuel as a Condition of Registration

Present Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.⁸ On such exception allows removal of diesel fuel without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This “dyed-fuel mandate” was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000.

Description of Proposal

The proposal would delay the effective date of the dyed-fuel mandate for an additional six months, through December 31, 2000. No other changes would be made to the present highway motor fuels excise tax rules.

⁸ Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

Effective Date

The proposal would be effective on the date of enactment.

L. Production Credit for Fuel Produced by Certain Coal Gasification Facilities

Present Law

Certain fuels produced from “nonconventional sources” and sold to unrelated parties are eligible for an income tax credit equal to \$1 (adjusted for inflation except in the case of tight sands gas) per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced in the United States. For 1999, the applicable credit rate is \$ 6.23 per oil barrel equivalent.

Qualified fuels include:

- (1) oil produced from shale and tar sands;
- (2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations (“tight sands”), or biomass; and
- (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Except with respect to fuel produced from coal and biomass facilities, the credit is available only for wells drilled or facilities placed in service before January 1, 1993. In the case of coal and biomass facilities, the credit is available for production from facilities placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (January 1, 2008 in the case of coal and biomass facilities subject to the later placed-in-service date described above).

Description of Proposal

The proposal would extend the date by which certain facilities must be placed in service through June 30, 2000. This extension would apply the coal and biomass facilities which under present law were required to be placed in service before July 1, 1998. The January 1, 1997, binding contract date and the January 1, 2008, production period expiration date would not be changed.

Credits allowed under the proposal that are attributable to periods before October 1, 2004, would not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code before October 1, 2004. Such credits would be available (without interest) on or after October 1, 2004, by filing an amended return, applying for an

expedited refund, applying for an adjustment of estimated tax payments, or by other means allowed under the Internal Revenue Code.

Effective Date

The proposal would be effective on the date of enactment.

II. REVENUE OFFSETS

A. Modification of Individual Estimated Tax Safe Harbor

Present Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For taxpayers with a prior year's AGI above \$150,000⁹, however, the rule that allows payment of 100 percent of prior year's tax is modified. Those taxpayers with AGI above \$150,000 generally must make estimated payments based on either (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

For taxpayers with a prior year's AGI above \$150,000, the prior year's tax safe harbor is modified for taxable years through 2002. For such taxpayers making estimated payments based on prior year's tax, payments must be made based on 105 percent of prior years tax for taxable years beginning in 1999, 106 percent of prior year's tax for taxable years beginning in 2000 and 2001, and 112 percent of prior year's tax for taxable years beginning in 2002.

Description of Proposal

For taxpayers with a prior year's AGI above \$150,000, the prior year's tax safe harbor would be modified for taxable years 2000 and 2004. For such taxpayers making estimated payments based on prior year's tax, payments must be made based on 110.5 percent of prior year's tax for taxable years beginning in 2000, and payments must be based on 112 percent of prior year's tax for taxable years beginning in 2004.

Effective Date

For taxable years beginning after December 31, 1999, and before January 1, 2001, taxpayers with prior year's AGI above \$150,000 who make estimated tax payments based on prior year's tax must do so based on 110.5 percent of the prior year's tax. For taxable years beginning after December 31, 2003, and before January 1, 2005, taxpayers with prior year's AGI above \$150,000 who make estimated payments based on prior year's tax must do so based on 112 percent of prior year's tax.

⁹ \$75,000 for married taxpayers filing separately.

B. Modify Foreign Tax Credit Carryover Rules

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Proposal

The proposal would reduce the carryback period for excess foreign tax credits from two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1999.

C. Clarify the Tax Treatment of Income and Losses on Derivatives

Present Law

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, or (4) certain copyrights (or similar property), and (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).

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).

Description of Proposal

The proposal would add three categories to the list of assets the gain or loss on which is treated as ordinary (sec. 1221). The new categories would be: (1) commodities derivative financial instruments entered into by derivative dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer’s trade or business.

In defining a hedging transaction, the proposal generally would codify the approach taken by the Treasury regulations, but would modify the rules. The “risk reduction” standard of the regulations would be broadened to one of “risk management” with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). In addition, the Treasury Secretary would be granted authority to treat transactions that manage other risks as hedging transactions. As under the present-law Treasury regulations, the transaction would have to be identified as a hedge of specified property. Authority would be provided for Treasury regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary also would be given authority to apply these rules to related parties.

Effective Date

The proposal would be effective for any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after the date of enactment.

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

Present Law

A manufacturer’s excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. The tax applies to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury

Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, “no fault” insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

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

In addition, the General Accounting Office (“GAO”) would be directed to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation and management of expenditures from the Vaccine Injury Compensation Trust Fund and to advise the Committees on the adequacy of the Vaccine Injury Compensation Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program. The GAO would report its findings to the House Committee on Ways and Means and the Senate Committee on Finance by January 31, 2000.

Effective Date

The proposal to include conjugate streptococcus pneumoniae vaccines would be effective for vaccine purchases beginning on the day after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugated streptococcus pneumoniae vaccines to children. No floor stocks tax would be collected for amounts held for sale on that date. The addition of conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines would be contingent upon the inclusion in this legislation of the modifications to Public Law 105-277.

E. Expand Reporting of Cancellation of Indebtedness Income

Present Law

Under section 61(a)(12), a taxpayer’s gross income includes income from the discharge of indebtedness. Section 6050P requires “applicable entities” to file information returns with the IRS regarding any discharge of indebtedness of \$600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided.

The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

“Applicable entities” include: (1) the FDIC, the RTC, the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

The penalties for failure to file correct information reports with the IRS and to furnish statements to taxpayers are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally \$50 per failure, subject to a maximum of \$100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Description of Proposal

The proposal would require that information reporting on discharges of indebtedness also be done by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date

The proposal would be effective with respect to discharges of indebtedness occurring after December 31, 1999.

F. Impose Limitation on Prefunding of Certain Employee Benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits.

The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

The present-law deduction limits for contributions to welfare benefit funds do not apply in the case of certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers.

If any portion of a welfare benefit fund reverts to the benefit of an employer that maintains the fund, an excise tax equal to 100 percent of the reversion is imposed on the employer.

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical benefits, disability benefits and qualifying group-term life insurance benefits to plan beneficiaries. Qualifying group-term life insurance benefits would 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. Also, it would be intended that qualifying group-term life insurance benefits would 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. Furthermore, it would be intended that group-term life insurance benefits would 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. The exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay and life insurance (other than group-term life) benefits. Thus, the generally applicable deduction limits (secs. 419 and 419A) would apply to plans providing these benefits.

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 would be treated as reverting to the benefit of the employers maintaining the fund and would be subject to the imposition of the 100-percent excise tax. 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.

No inference would be intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The proposal would be effective with respect to contributions paid or accrued on or after June 9, 1999, in taxable years ending after such date.

G. Increase Elective Withholding Rate for Nonperiodic Distributions from Deferred Compensation Plans

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,¹⁰ (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)

¹⁰All IRA distributions are treated as if includible in income for purposes of this rule.

of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over the a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from section 401(k) plans, or the portion of a distribution that is not includible in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

Description of Proposal

Under the proposal, the withholding rate for nonperiodic distributions would be increased from 10 percent to 15 percent. As under present law, unless the distribution was an eligible rollover distribution, the payee could elect not to have withholding apply. The proposal would not modify the 20-percent withholding rate that applies to any distribution that is an eligible rollover distribution.

Effective Date

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

H. Limit Conversion of Character of Income from Constructive Ownership Transactions

Present Law

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on long-term capital gain generally is 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.¹¹

A pass-thru entity (such as a partnership) generally is not subject to Federal income tax. Rather, each owner includes its share of a pass-thru entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar

¹¹ Section 1234A, as amended by the Taxpayer Relief Act of 1997.

economic benefits as owning the property directly but with potentially different tax consequences as to the character and timing of any gain.

Description of Proposal

The proposal would limit the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts (“constructive ownership transactions”) with respect to certain financial assets. The amount of long-term capital gain would be limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount would be treated as ordinary income. An interest charge would be imposed on the amount of gain that is treated as ordinary income.

A taxpayer would be treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to a financial asset, (2) enters into a forward contract to acquire a financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

A “financial asset” would be defined as (1) any equity interest in a pass-thru entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. A “pass-thru entity” would be defined as (1) a regulated investment company, (2) a real estate investment trust, (3) a real estate mortgage investment conduit, (4) an S corporation, (5) a partnership, (6) a trust, (7) a common trust fund, (8) a passive foreign investment company,¹² (9) a foreign personal holding company, and (10) a foreign investment company.

The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer’s income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued at a constant rate¹³ during the term of the constructive ownership transaction.

A taxpayer would be treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all

¹² For this purpose, a passive foreign investment company includes an investment company that is also a controlled foreign corporation.

¹³ The accrual rate would be the applicable Federal rate on the day the constructive ownership transaction closed.

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.

No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this proposal.

Effective Date

This proposal would apply to transactions entered into on or after July 12, 1999. For this purpose, 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.

I. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Present Law

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health 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, 2000.¹⁴

Description of Proposal

The present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account would be extended through September 30, 2009. In addition, the present-law minimum benefit requirement would be replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under

¹⁴ Similar provisions regarding transfers of excess defined benefit pension plan assets to retiree health accounts are contained in title I of the Employee Retirement Income Security Act (“ERISA”).

which applicable health benefits are provided would be required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level would be the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year would be determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

Effective Date

The proposal generally would be effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before October 1, 2009. The replacement of the present-law minimum benefit requirement with the minimum cost requirement generally would be effective for qualified transfers occurring on or after the date of enactment. The minimum benefit requirement would continue to apply to qualified transfers before the date of enactment. An employer would be permitted to satisfy the minimum benefit requirement with respect to a qualified transfer that occurs on or after the date of enactment during the portion of the cost maintenance period of such transfer that overlaps the benefit maintenance period of a qualified transfer that occurs before the date of enactment. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer would be permitted to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and would be required to satisfy the minimum cost requirement in 2003 and 2004.

J. Modify Installment Method and Prohibit its Use by Accrual Method Taxpayers

Present Law

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B)) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds¹⁵ 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(1)(2)(B), or to dispositions where the sales price does not exceed \$150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

Description of Proposal

Prohibition on the use of the installment method for accrual method dispositions

The proposal would generally prohibit the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The proposal would not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The proposal also would not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(1).

The proposal would not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for next ten years. The proposal would not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

Modifications to the pledge rule

The proposal would modify the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the

¹⁵ The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the proposal, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to “put” or repay the loan by transferring the installment note to the taxpayer’s creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the proposal would not change the treatment of installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(1)(2)(B), to sales of property used or produced in the trade or business of farming, or to dispositions where the sales price does not exceed \$150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The proposal would be effective for sales or other dispositions entered into on or after the date of enactment.

K. Limitation on the Use of Non-accrual Experience Method of Accounting

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.

Description of Proposal

The proposal 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 proposal would be effective for taxable years ending after the date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal would be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment would be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98-60.¹⁶

L. Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements

Present Law

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the

¹⁶ 1998-51 I.R.B. 16.

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.¹⁷

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no deduction is allowed for any contribution of \$250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (sec. 170(f)(8)).

Description of Proposal

Deduction denial

The proposal¹⁸ would restate present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract" with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It would be intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor would be any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It would be intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it would not be intended that the deduction denial rule under the proposal apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor would

¹⁷ United States v. American Bar Endowment, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

¹⁸ The proposal is similar to H.R. 630, introduced by Mr. Archer and Mr. Rangel (106th Cong., 1st Sess.).

be considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) would not prevent it from being a personal benefit contract. The proposal would not be intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It would be intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary would not be intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity would not be treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. sec. 20.2042-1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the proposal, an individual's family would consist of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) would be treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by the proposal) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person would not be treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference would be intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the proposal would be intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The proposal would impose on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the proposal (without regard to when the transfer to the charitable organization was made). The excise tax would not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the proposal, payments would be treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The proposal would require that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the proposal, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it would be intended that a beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 would apply to returns under this reporting requirement. Returns required under this proposal are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The proposal would provide for the promulgation of regulations necessary or appropriate to carry out the purposes of the proposal, including regulations to prevent the avoidance of the purposes of the proposal. For example, it would be intended that regulations prevent avoidance of the purposes of the proposal by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under bona fide charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial proposal would apply to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax proposal would apply to premiums paid after the date of enactment. The reporting proposal would apply to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the proposal applied to premiums paid after that date).

No inference would be intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The proposal would not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the proposal.

M. Prevent Duplication or Acceleration of Loss Through Assumption of Certain Liabilities

Present Law

Generally, no gain or loss is recognized when one or more persons contribute property in exchange for stock and immediately after the exchange such person or persons control the corporation. However, the person may recognize gain to the extent it receives money or other property (“boot”) as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor. One exception to this rule is when, “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)). Another exception applies to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

In general, the transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased in the amount of any gain recognized by the transferor on the exchange, and reduced by the amount of any money or property received (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

Special rules apply in connection with the assumption of a liability that would give rise to a deduction. These liabilities are not taken into account in determining whether the transferor has gain on the exchange, and the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of these liabilities. The Internal Revenue Service has ruled that the assumption of certain contingent liabilities by an accrual basis corporation is covered by this rule.¹⁹

Description of Proposal

The proposal would provide that if the basis of stock received by a transferor as part of a tax-free exchange with a controlled corporation would exceed its fair market value (without regard to this proposal), then the basis of the stock received would be reduced (but not below the fair market value) by the amount of any liability that (1) is assumed in exchange for such property, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. The proposal would not apply where the trade or business giving rise to the liability is transferred to the corporation as part of the exchange. For this purpose, the term "liability" would include any obligation to make payment, without regard to whether the obligation is fixed or contingent or otherwise taken into account under the Code.

The Secretary of the Treasury would be directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities (as defined in the proposal) in transactions involving partnerships.

Effective Date

The proposal would be effective for assumptions of liabilities on or after October 19, 1999. Except as provided by the Secretary of the Treasury, the rules addressing transactions involving partnerships would be effective for assumptions of liabilities on or after October 19, 1999.

N. Require Consistent Treatment and Provide Basis Allocation Rules for Transfers of Intangibles in Certain Nonrecognition Transactions

¹⁹ Rev. Rul. 95-74, 1995-2 C.B. 36.

Present Law

Generally, no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and, immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Internal Revenue Code nor the regulations provide the meaning of the requirement that a person “transfer property” in exchange for stock (or a partnership interest). The Internal Revenue Service interprets the requirement consistent with the “sale or other disposition of property” language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69-156, 1969-1 C.B. 101. Thus, a transfer of less than “all substantial rights” to use property will not qualify as a tax-free exchange and stock received will be treated as payments for the use of property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the Service's position and held that the transfer of a nonexclusive license to use a patent (or any transfer of “something of value”) could be a “transfer” of “property” for purposes of the nonrecognition provision. See E.I. DuPont de Nemours & Co. v. U.S., 471 F.2d 1211 (Ct. Cl. 1973).

Description of Proposal

The proposal would treat a transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor in the property as a transfer of property for purposes of the nonrecognition provisions regarding transfers of property to controlled corporations and partnerships. Consistent reporting by the transferor and transferee would be required. Furthermore, in the case of a transfer of less than all of the substantial rights, the transferor would be required to allocate the basis of the intangible between the retained rights and the transferred rights based upon respective fair market values.

No inference is intended as to the treatment of these or similar transactions prior to the effective date.

Effective Date

The proposal would be effective for transfers on or after the date of enactment.

O. Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation

Present Law

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The basis of property received by a

corporate distributee in the distribution in complete liquidation of the 80-percent-owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under section 332.²⁰

Description of Proposal

In general

The proposal would provide for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction would apply if, after the distribution, the corporate partner controls the distributed corporation.

Amount of the basis reduction

²⁰ 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).

Under the proposal, the amount of the reduction in basis of property of the distributed corporation generally would equal the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The proposal would limit the amount of the basis reduction in two respects. First, the amount of the basis reduction could not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Thus, for example, if the distributed corporation has cash of \$300 and other property with a basis of \$600 and the corporate partner's basis in the stock of the distributed corporation is \$400, then the amount of the basis reduction could not exceed \$500 (i.e., $(\$300 + \$600) - \$400 = \500).

Second, the amount of the basis reduction could not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the proposal, even though the total amount of the basis reduction would otherwise be greater.

The proposal would provide that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction does exceed the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution would be 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 proposal. The corporate partner's basis in the stock of the distributed corporation would also be increased by \$100 in this example, under the proposal.

The basis reduction would 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 would apply with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

The proposal would apply to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The proposal would not apply to any distribution if the corporate partner does not have control of

the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the proposal, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to section 732(a)(2) or (b), then the corporation would be treated as receiving a distribution of stock from a partnership. For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in a section 351 transaction, then the stock received in the section 351 transaction would not be treated as distributed by a partnership, and the basis reduction under this proposal would not apply. As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger would be treated as received in a partnership distribution; the basis reduction rule of the proposal would apply.

In the case of tiered corporations, a special rule would provide that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the proposal is applied to reduce the basis of the property of that controlled corporation. The proposal would also be 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 would be applied again to reduce the basis of the assets of the subsidiary, under the special rule.

The proposal would also provide for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the proposal. It would be intended that regulations prevent the avoidance of the purposes of the proposal through the use of tiered partnerships.

Effective Date

The proposal would be effective for distributions made after July 14, 1999, except that in the case of a corporation that is a partner in a partnership on July 14, 1999, the proposal would be effective for distributions by that partnership to the corporation after the date of enactment.

P. Prohibited Allocations of Stock in an S Corporation ESOP

Present Law

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of

the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

Description of Proposal

In general

The proposal contains rules designed to limit deferral opportunities in the case of a closely-held ESOP maintained by an S corporation. Under the proposal, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person would be treated as distributed to such individual (i.e., the value of the prohibited allocation would be includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax would be imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax would be imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.

Definition of nonallocation year

A nonallocation year would mean any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation.

A person would be a disqualified person if the person is either (1) a member of a "deemed 20-percent shareholder group" or (2) a "deemed 10-percent shareholder." A person would be a member of a "deemed 20-percent shareholder group" if the number of deemed-owned shares of the person and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation. A person would be a deemed 10-percent shareholder if the person is not a member of a deemed 20-percent shareholder group and the number of the person's deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation.

In general, “deemed-owned shares” would mean: (1) stock allocated to the account of the individual under the ESOP, and (2) an individual’s share of unallocated stock held by the ESOP. An individual’s share of unallocated stock held by an ESOP would be determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether disqualified persons own 50 percent or more of the outstanding stock of the corporation, deemed-owned shares and shares owned directly by an individual would be taken into account. The family attribution rules of section 318 would apply, modified to include certain other family members, as described below.

Under the proposal, family members of an individual would 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 proposal contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based would be treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment would result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year would include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

“Synthetic equity” would mean any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity would also include a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.²¹

Definition of prohibited allocation

An ESOP of an S corporation would be required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A “prohibited allocation” refers to violation of this

²¹ The provisions in the proposal relating to synthetic equity would not be intended to modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

provision. A prohibited allocation would occur, for example, if income on S corporation stock held by an ESOP were allocated to the account of an individual who is a disqualified person.

Application of excise tax

In the case of a prohibited allocation, the S corporation would be liable for an excise tax equal to 50 percent of the amount of the allocation. For example, if S corporation stock were allocated in a prohibited allocation, the excise tax would be equal to 50 percent of the fair market value of such stock.

A special rule would apply in the case of the first nonallocation year in which there is a prohibited allocation. In that year, the excise tax would also apply to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

As mentioned above, the S corporation would also be liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax would be 50 percent of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department would be given the authority to prescribe such regulations as may be necessary to carry out the purposes of the provision.

Effective Date

The proposal generally would be 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 proposal would be effective with respect to plan years ending after July 14, 1999.

Q. Treatment of Real Estate Investment Trusts (“REITs”)

1. Provisions Relating to REITs

Present Law

Real estate investment trust (“REITs”) are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are restricted to investing in passive investments primarily in real estate and securities. Specifically, a REIT is required to receive at least 95 percent of its income from real property rents and from securities. Amounts received as impermissible “tenant services income” are not treated as rents from real property. In general,

such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property. Special rules permit amounts to be received from certain “foreclosure property,” treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness which such property secured.

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

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities of any corporate issuer. Under an exception to this rule, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.²²

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

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 as 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

²² 15 U.S.C. 80a-1 and following.

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

Description of Proposal

Taxable REIT subsidiaries

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

For purposes of the new 10-percent value test, securities would be 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 would be excluded from the definition of securities only if the REIT owns at least 20-percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly, even though it may also derive qualified interest income through its safe harbor debt interest.

An exception to the limitations on ownership of securities of a single issuer would apply in the case of a “taxable REIT subsidiary” that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 20 percent of the total value of a REIT’s assets.

A taxable REIT subsidiary would be able to engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary’s activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary could provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and could manage or operate properties

generally, without causing amounts received or accrued directly or indirectly by REIT for such activities to fail to be treated as rents from real property.

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

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

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

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

Under the bill, rents paid to a REIT are not generally qualified rents if the REIT owns more than 10 percent of the value, (as well as of the vote) of a corporation paying the rents. The only exception is for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90 percent of space is leased to third parties) or the exception for certain lodging facilities (operated by an independent contractor).

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 would be imposed on the portion that was excessive. "Safe harbors" would be provided for certain rental payments where the amounts are de minimis, there is specified evidence that charges to unrelated parties are substantially comparable, certain charges for services from the taxable REIT subsidiary are separately stated, or the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

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

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

Health Care REITS

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

Conformity with regulated investment company rules

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

Definition of independent contractor

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

Modification of earnings and profits rules for RICs and REITS

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

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

modified to apply the same earnings and profits ordering rule to such dividends as other REIT dividends.

Effective Date

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

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

The new 10 percent of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999 and at all times thereafter.

2. Modify estimated tax rules for closely held REITs

Present Law

If a person has a direct interest or a partnership interest in income producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g. mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case

if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

Description of Proposal

In the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT would be required to accelerate the recognition of year-end dividends attributable to the closely held REIT for purposes of such person's estimated tax payments. A closely held REIT would be defined as one in which at least 50 percent of the vote or value is owned by five or fewer persons. Attribution rules would apply to determine ownership.

Effective Date

The proposal would be effective for estimated tax payments due on or after September 15, 1999.

3. Modify treatment of closely-held REITs

Present Law

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to tax at the REIT level.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's: (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income.

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination. No similar rule applies to corporate ownership of a REIT. Certain transactions have been structured to attempt to achieve special tax benefits for an entity that controls a REIT.

Description of Proposal

The proposal would impose as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no one person 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 independent contractor qualification under present law would apply (secs. 856(d)(5) and 856(h)(3)). The proposal would not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception would apply for a limited period to certain “incubator REITs”. An incubator REIT 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 directors of the corporation must adopt a resolution setting forth an intent to engage in a going public transaction, (5) the corporation must annually increase the value of real estate assets by 10 percent, and (6) no predecessor entity (including any entity from which the electing incubator REIT acquired assets in a transaction in which gain or loss was not recognized in whole or in part) had elected incubator REIT status.

The new ownership requirement would not apply to an electing incubator REIT until the end of the REIT’s third taxable year; and could be extended for an additional two taxable years if the REIT so elects. However, a REIT cannot elect the additional two year extension unless the REIT agrees that if it does not engage in a going public transaction by the end of the extended eligibility period, it shall pay Federal income taxes for the two years of the extended period as if it had not made an incubator REIT election and had ceased to qualify as a REIT for those two taxable years. In such case, the corporation shall file appropriate amended returns within 3 months of the close of the extended eligibility period. Interest would be payable, but no substantial underpayment penalties would apply except in cases where there is a finding that incubator REIT status was elected for a principal purpose other than as part of a reasonable plan to engage in a going public transaction. Notification of shareholders and any other person whose tax position would reasonably be expected to be affected is also required.

If an electing incubator REIT does not elect to extend its initial 2-year extended eligibility period and has not engaged in a going public transaction by the end of such period, it must satisfy the new control requirements as of the beginning of its fourth taxable year (i.e., immediately after the close of the last taxable year of the two-year initial extension period) or it will be required to notify its shareholders and other persons that may be affected by its tax status, and pay Federal income tax as a corporation that has ceased to qualify as a REIT at that time.

If the Secretary of the Treasury determines that an incubator REIT election was filed for a principal purpose other than as part of a reasonable plan to undertake a going public transaction, an excise tax of \$20,000 is imposed on each of the corporation’s directors for each taxable year for which the election was in effect.

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. and once stock is deemed owned by a qualified entity (a REIT or a partnership of which a REIT is at least a 50 percent partner) it will not be reattributed under section 318(a)(3)(C). In addition, in the case of ownership by a partnership or S corporation, ownership is determined by looking through to the partners or shareholders, provided certain requirements are met.

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.

Effective Date

The proposal would be 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.