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General Explanations  
of the  
Administration's Revenue Proposals

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Department of the Treasury  
February 1999

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## **Making Health Care More Affordable**

### **ASSISTING TAXPAYERS WITH LONG-TERM CARE NEEDS**

#### **Current Law**

Several provisions in the tax code provide assistance to taxpayers with a disabled family member or with long-term care expenses. A taxpayer can receive a child and dependent care tax credit for expenses incurred to care for a disabled spouse or dependent so the taxpayer can work. A low-income working taxpayer can qualify for the earned income tax credit if he or she resides with a disabled child (of any age). A taxpayer who itemizes can deduct expenses for qualified long-term care services if he or she is chronically ill or such expenses were incurred on behalf of a chronically ill spouse or dependent.

#### **Reasons for Change**

A long illness or a disability can impose significant burdens on individuals and their caregivers. Taxpayers who have long-term care needs or who care for others with such needs do not have the same ability to pay taxes as other taxpayers. Providing a tax credit is an equitable and efficient way of recognizing the formal and informal costs of providing long-term care.

#### **Proposal**

A taxpayer would be allowed to claim a \$1,000 credit if he or she has long-term care needs. A taxpayer also would be allowed to claim the credit with respect to a spouse or each qualifying dependent who has long-term care needs.<sup>1</sup> The credit (aggregated with the child credit and the proposed disabled worker credit) would be phased-out for certain high-income taxpayers--that is, the aggregate credit amount would be phased out by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds \$110,000 (in the case of a joint return), \$75,000 (in the case of a taxpayer who is not married), or \$55,000 (in the case of a married individual filing a separate return).

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<sup>1</sup> To qualify as a dependent, an individual must (1) be a specified relative or member of the taxpayer's household; (2) be a citizen or resident of the U.S. or resident of Canada or Mexico; (3) not be required to file a joint tax return with his or her spouse; (4) have gross income below the dependent exemption amount (\$2,750 in 1999) if not the taxpayer's child; and (5) receive over half of his or her support from the taxpayer. The taxpayer may be deemed as providing over half the cost of supporting the individual if (a) no one person contributes over half the support of such individual; (b) over half the support is received from persons each of whom, but for the fact that he or she did not provide over half such support, could claim the individual as a dependent; (c) the taxpayer contributes over 10 percent of such support; and (d) the other caregivers, who provide over 10 percent of the support, file written declarations stating that they will not claim the individual as a dependent.

For purposes of the proposed tax credit only, the dependency tests of section 151 would be modified in two ways. First, the gross income threshold would increase to the sum of the personal exemption amount, the standard deduction, and the additional deduction for the elderly and blind (if applicable). In 1999, the gross income threshold would generally be \$7,050 for a non-elderly single dependent and \$8,100 for an elderly single dependent.

Second, the current-law support tests would be deemed to be met if the taxpayer and an individual with long-term care needs reside together for a specified period. The length of the specified period would depend on the relationship between the taxpayer and the individual with long-term care needs. The specified period would be over half the year if the individual is the parent (including stepparents and in-laws), or ancestor of the parent, or child, or descendant of the child, of the taxpayer. Otherwise, the individual must reside with the taxpayer the full year. If more than one taxpayer resides with the person with long-term care needs and would be eligible to claim the credit for that person, then those taxpayers generally must designate the taxpayer who will claim the credit. If the taxpayers fail to do so or if they are married to each other and filing separate returns, then only the taxpayer with the highest adjusted gross income would be eligible to claim the credit.

An individual age six or older would be considered to have long-term care needs if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least six months to perform at least three activities of daily living (ADLs) without substantial assistance from another individual, due to a loss of functional capacity (including individuals born with a condition that is comparable to a loss of functional capacity).<sup>2</sup> As under section 7702B(c)(2)(B), ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include both hands-on assistance (that is, the physical assistance of another person without which the individual would be unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when performing the ADL).

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

A child between the ages of two and six would be considered to have long-term care needs if he or she were certified by a licensed physician as requiring substantial assistance for at least six

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<sup>2</sup> A portion of the period certified by the physician must occur within the taxable year for which the credit is claimed. After the initial certification, individuals must be re-certified by their physician within three years or such other period as the Secretary prescribes.

months with two of the following activities: eating, transferring, and mobility. A child under the age of two would qualify if he or she were certified by a licensed doctor as requiring for at least six months specific durable medical equipment (for example, a respirator) by reason of a severe health condition or requiring a skilled practitioner trained to address the child's condition when the parents are absent. Within five years of enactment, the Department of the Treasury and the Department of Health and Human Services would report to Congress on the effectiveness of the definition of disability for children and recommend, if necessary, modifications to the definition.

The taxpayer would be required to provide a correct taxpayer identification number for the individual with long-term care needs, as well as a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying physician. Failure to provide correct taxpayer and physician identification numbers would be subject to mathematical error procedures. Further, the taxpayer could be required to provide other proof of the existence of long-term care needs in such form and manner, and at such times, as the Secretary requires.

The credit would be coordinated with the current law child credit and the proposed disabled workers credit to allow these credits to be refundable for a taxpayer claiming three or more credit amounts.<sup>3</sup> As under the current-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation of section 26(a) were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

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

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<sup>3</sup> More than one credit amount could be attributable to a single individual. For example, a disabled worker with long-term care needs would have two credit amounts—a disabled workers credit and a long-term care credit. Similarly, a taxpayer with a child under age 17 with long-term care needs would have two credit amounts—a child credit and a long-term care credit—for that child.

## **DISABLED WORKERS TAX CREDIT**

### **Current Law**

Taxpayers who are handicapped may claim an itemized deduction for impairment-related work expenses. The deduction is treated as a miscellaneous deduction subject to the two-percent of adjusted gross income (AGI) floor.

A handicapped individual is defined as any individual who has a physical or mental disability (including, but not limited, to blindness or deafness), which for such individual constitutes or results in a functional limitation to employment, or who has any physical or mental impairment (including, but not limited to, a sight or hearing impairment), which substantially limits one or more major life activities.

Impairment-related work expenses are defined as expenses for attendant care services at the individual's place of employment and other expenses in connection with such place of employment which are necessary for the individual to be able to work. Impairment-related work expenses must be ordinary and necessary.

Depreciable capital items are not included under the definition of impairment-related work expenses. Depreciation attributable to these items, however, may be deductible, subject to certain limitations (such as, for example, the two-percent AGI floor).

### **Reasons for Change**

Disabled individuals may incur additional costs in order to work and earn taxable income, and thus do not have the same ability to pay as taxpayers who do not incur such expenses. However, many moderate-income disabled individuals do not benefit from the current-law tax deduction for impairment-related work expenses because they do not have sufficient work-related expenses and other deductions to benefit from itemizing deductions. In addition, many disabled individuals do not benefit from the current-law deduction because they incur significant work-related expenses outside the workplace (which do not qualify for the deduction) or rely on unpaid relatives or friends for assistance. For example, they may require personal assistance to get dressed and driven to work.

### **Proposal**

A taxpayer would qualify for a \$1,000 tax credit if he or she had earned income and was disabled. The credit could not exceed the disabled individual's earned income during the tax year. The credit (aggregated with the child credit and the proposed long-term care credit) would be phased-out for certain high-income taxpayers--that is, the aggregate credit amount would be phased out by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds \$110,000 (in the case of a joint return), \$75,000 (in the case of a taxpayer who is not married), or \$55,000 (in the case of a married individual filing a separate return).

A taxpayer with earned income would be considered to be a disabled worker if he or she were certified by a licensed physician (prior to the filing of a return claiming the credit) as being unable for at least 12 months to perform at least one activity of daily living without substantial assistance from another individual, due to loss of functional capacity.<sup>4</sup> As under section 7702B(c)(2)(B), activities of daily living would be eating, toileting, transferring, bathing, dressing, and continence. A taxpayer could potentially qualify for both the proposed long-term care credit and the disabled workers tax credit.

The taxpayer would be required to provide a correct physician identification number (e.g., the Unique Physician Identification Number that is currently required for Medicare billing) for the certifying doctor. Failure to provide the correct physician identification number would be subject to mathematical error procedures. Further, the taxpayer could be required to provide other proof of the existence of disability in such form and manner, and at such times, as the Secretary requires.

The credit would be coordinated with the current law child credit and the proposed long-term care credit to allow these credits to be refundable for a taxpayer claiming three or more credit amounts.<sup>5</sup> As under the current-law child credit, the amount of refundable credit would be the amount that the nonrefundable personal credits would increase if the tax liability limitation of section 26(a) were increased by the excess of the taxpayer's social security taxes over the taxpayer's earned income credit (if any).

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

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<sup>4</sup> A portion of the period certified by the physician must occur within the taxable year for which the credit is claimed. After the initial certification, individuals must be re-certified by their physician within three years or such other period as the Secretary prescribes.

<sup>5</sup> More than one credit amount could be attributable to a single individual. For example, a disabled worker with long-term care needs would have two credit amounts—a disabled workers credit and a long-term care credit. Similarly, a taxpayer with a child under age 17 with long-term care needs would have two credit amounts—a child credit and a long-term care credit—for that child.

## **PROVIDE TAX RELIEF TO ENCOURAGE SMALL BUSINESS HEALTH PLANS**

### **Current Law**

Employer contributions toward employee accident or health insurance are generally deductible by employers and excluded from gross income by employees. An employee's share of his or her health insurance premiums is an itemized deduction, but is deductible only to the extent that medical or long-term care expenses (including health insurance costs) exceed 7.5 percent of the employee's adjusted gross income.

A self-employed individual may deduct as a trade or business expense a percentage (60 percent in 1999, increasing to 70 percent in 2002 and 100 percent in 2003) of insurance premiums covering the individual and his or her family, but only if the individual is not eligible to participate in a subsidized health plan maintained by any employer of the individual or of the individual's spouse. The deduction is limited by the self-employed individual's earned income derived from the relevant trade or business.

A multiple employer welfare arrangement, or MEWA, is an employee benefit plan or other arrangement that provides medical or certain other benefits to employees of two or more employers. MEWAs are generally subject to applicable State insurance laws, including provisions of State insurance law that generally comply with requirements imposed on insurance issuers under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and subsequent federal laws. MEWAs (whether or not funded through insurance) are also regulated under the Employee Retirement Income Security Act (ERISA) with respect to reporting, disclosure, fiduciary, and claims procedures.

Private foundation grants must be used for charitable purposes. To ensure that foundation grants are used for the intended charitable purpose, so-called "expenditure responsibility" requirements apply whenever such grants are made to non-charitable organizations for exclusively charitable purposes. These requirements involve certain recordkeeping and reporting requirements. Among other things, there must be a written agreement between the foundation and the grantee that specifies clearly how the grant funds will be expended, the grantee's books and records must account separately for the grant funds, and the grantee must report annually to the foundation on the use of the grant funds and the progress made in accomplishing the purposes of the grant.

### **Reasons for Change**

Over a quarter of private-sector workers in firms with 50 or fewer employees lack health insurance -- significantly more than the national average (about 17 percent of workers). This deficiency in insurance coverage occurs, in part, because the costs of setting up and operating health plans in the current small business insurance market are higher than those for larger employers. Consequently, small employers tend to pay more for similar employee health insurance benefits than do larger employers. In addition, insurance companies may need a minimum number of covered

employees in order to be able to provide insurance to a group. This makes it difficult for small employers to offer multiple health plans to their employees. Only a tiny fraction of the small businesses that offer health insurance benefits provide their workers with a choice of health plans.

Health benefit purchasing coalitions pool employer workforces, negotiate with insurers over health plan benefits and premiums, provide comparative information about available health plans to participating employees, and may administer premium payments made by employers and their participating employees. Such coalitions provide an opportunity for small employers to purchase health insurance for their workers at reduced cost and to offer a greater choice of health plans than is currently available to employees of small businesses.

The formation of health benefit purchasing coalitions has been hindered by their limited access to capital, but some private foundations have indicated a willingness to fund coalition start-up expenses. However, private foundations are prohibited under the Internal Revenue Code from making grants for other than charitable purposes. Current law provides no assurance that the funding of start-up expenses of health benefit purchasing coalitions would qualify as a “charitable purpose.” Consequently, private foundations are reluctant to make grants to fund coalition start-up expenses.

### **Proposal**

The proposal has two parts. First, it would establish a special rule that will facilitate private foundation grants to qualified health benefit purchasing coalitions. Second, it would create a new income tax credit designed to encourage use of these purchasing coalitions by small businesses that currently do not provide health insurance to their workforces. Both provisions would be temporary and are proposed to expire after a set period of time.

### **Foundation Grants to Qualified Health Benefit Purchasing Coalitions**

Any grant or loan made by a private foundation to a qualified health benefit purchasing coalition (“qualified coalition”) to support the coalition’s initial operating expenses would be treated as a grant or loan made for charitable purposes. As with any other grant or loan to a non-charitable organization for exclusively charitable purposes, private foundations would be required to comply with the “expenditure responsibility” record-keeping and reporting requirements under current law.

Initial operating expenses of a qualified coalition would include all ordinary and necessary expenses incurred in connection with the establishment of the qualified coalition and its initial operations, including the payment of reasonable compensation for services provided to the qualified coalition and rental payments. In addition, initial operating expenses would include the cost of tangible personal property purchased by the qualified coalition for its own use. Initial operating expenses would not include (1) the purchase of real property, (2) any payment made to, or for the benefit of, members (or employees or affiliates of members) of the qualified coalition, such as any payment of insurance premiums on policies insuring members (or their employees or affiliates), or (3) any expense incurred more than 24 months after the date of formation of the coalition.

## Requirements Imposed on Qualified Health Benefit Purchasing Coalitions

A qualified health benefit purchasing coalition would be required to operate on a non-profit basis and to be formed as a separate legal entity whose objective is to negotiate with health insurers for the purpose of providing health insurance benefits to the employees of its small business members. A qualified coalition would be authorized to collect and distribute health insurance premiums and provide related administrative services. It would need to be certified annually by an appropriate State or federal agency as being in compliance with the following requirements. Its board would be required to have both employer and employee representatives of its small business members, but could not include service providers, health insurers, insurance agents or brokers, and others who might have a conflict of interest with the coalition's objectives. The qualified coalition could not bear insurance or financial risk, or perform any activity relating to the licensing of health plan issuers. Where feasible, the coalition would have to enter into agreements with three or more unaffiliated, licensed health plans, and would be required to offer at least one open enrollment period per calendar year. The qualified coalition would have to service a significant geographic area, but would not be required to cross State boundaries. It would be required to accept as members all eligible employers on a first-come, first-served basis, and would need to market its services to all eligible employers within its designated area. An eligible employer would be defined as any small employer, as defined under HIPAA (generally, businesses that employ an average of at least two, but not more than 50, employees)..

Qualified coalitions would be subject to HIPAA and subsequent federal health laws, including participant nondiscrimination rules and provisions applicable to MEWAs under ERISA and the Code. Thus, coalition health plans could not discriminate against any individual participant as regards enrollment eligibility or premiums on the basis of his or her health status or claims experience. In addition, employers would have guaranteed renewability of health plan access. Health plans sold through qualified coalitions would also be required to meet State laws concerning health insurance premiums and minimum benefits. State "fictitious group" laws would be preempted, and States would be required to permit an insurer to reduce premiums negotiated with a qualified coalition in order to reflect administrative and other cost savings or lower profit margins. Health plans sold through qualified coalitions would not be considered to be 10-or-more employer plans for purposes of the welfare benefit fund rules. Accordingly, participating employers would be subject to the welfare benefit fund contribution limits.

## Small Business Health Plan Tax Credit

The second part of the proposal would create a temporary tax credit for small businesses to encourage the purchase of employee health insurance through qualified health benefit purchasing coalitions. The credit would be available to employers with at least two, but not more than 50, employees, counting only employees with annual compensation (including 401(k) and SIMPLE employer contributions) of at least \$10,000 in the prior calendar year. Eligible employers could not have had an employee health plan during any part of 1997 or 1998, and they would be required to purchase insurance through a qualified coalition. The credit would equal ten percent of employer



contributions to employee health plans. The maximum credit amount per policy would be \$200 per year for individual coverage and \$500 per year for family coverage (to be ratably reduced if coverage is provided for less than 12 months during the employer's taxable year). The credit would be allowed to a qualifying small employer only with respect to contributions made during the first 24 months that the employer purchases health insurance through a qualified coalition. For employers that begin to purchase health insurance in 1999, this 24-month limit would not include months beginning before January 1, 2000. As a condition of qualifying for the credit, employers would need to cover 70 percent of those workers who have compensation (including 401(k) and SIMPLE employer contributions) of at least \$10,000 and who are not covered elsewhere by a health plan. A self-employed individual who is eligible to take a business deduction for his or her family's health insurance premiums would not be allowed to include any of those insurance premiums in the calculation of the credit amount. The small business health plan credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit.

#### Effective Dates

The proposal would be effective for taxable years beginning after December 31, 1999. The special foundation rule would apply to grants and loans made prior to January 1, 2004 for initial operating expenses incurred prior to January 1, 2006. The credit would be available only for health plans established before January 1, 2004. No carrybacks of the credit would be allowed to taxable years beginning before January 1, 2000.

## **Expand Education Initiatives**

### **PROVIDE TAX CREDITS FOR HOLDERS OF QUALIFIED SCHOOL MODERNIZATION BONDS AND QUALIFIED ZONE ACADEMY BONDS**

#### **Current Law**

Under current law, State and local governments fund public school construction by issuing bonds the interest on which generally is exempt from Federal income tax. In addition, State and local governments can issue “qualified zone academy bonds” to fund the improvement of certain eligible public schools. An eligible holder of a qualified zone academy bond receives annual Federal income tax credits. These annual credits compensate the holder for lending money and, therefore, are treated like taxable interest payments for Federal tax purposes. Eligible holders are banks, insurance companies, and corporations actively engaged in the business of lending money. The “credit rate” on a qualified zone academy bond is used to determine the amount of the annual tax credit and currently is set by regulations at 110 percent of the applicable federal rate (AFR) for the month in which the bond is issued. The maximum term of a qualified zone academy bond issued during any month is determined by reference to the “adjusted” AFR for the month in which the bond is issued.

A total of \$400 million of qualified zone academy bonds may be issued in each of 1998 and 1999. The annual cap is allocated among the States in proportion to their respective populations of individuals with incomes below the poverty line. Unused authority to issue qualified zone academy bonds may be carried forward to subsequent years.

There are a number of requirements that must be met for a bond to be treated as a qualified zone academy bond. First, the bond must be issued pursuant to an allocation of bond authority from the issuer’s State educational agency. Second, at least 95 percent of the bond proceeds must be used for an eligible purpose at a qualified zone academy. Eligible purposes include renovating school facilities, acquiring equipment, developing course materials, or training teachers. A qualified zone academy is a public school (or an academic program within a public school) that is designed in cooperation with business and is either (1) located in an empowerment zone or enterprise community, or (2) attended by students at least 35 percent of whom are estimated to be eligible for free or reduced-cost lunches under the National School Lunch Act. Third, private business entities must have promised to contribute to the qualified zone academy certain property or services with a present value equal to at least 10 percent of the bond proceeds.

#### **Reasons for Change**

Aging school buildings, new educational technologies, growing enrollments, the need for smaller class sizes, and changing demographics have created a need to renovate older school buildings and to build new ones. Many school systems have insufficient fiscal capacity to finance needed renovation and new construction. The proposal would leverage Federal support to spur new State

and local investment in public schools. Minor changes in the structure of qualified zone academy bonds will allow them to be marketed more easily.

## **Proposal**

The proposal would authorize the issuance of two types of bonds; qualified school modernization bonds and qualified zone academy bonds. These bonds would be issued as “tax credit bonds,” that is, they would provide the holder a Federal income tax credit in lieu of an interest payment. As described elsewhere, “Better America Bonds” are also proposed using the same tax credit bond format. The common features of tax credit bonds will speed the development of efficient primary and secondary markets for all three types of bonds.

### **Qualified school modernization bonds**

State and local governments would be able to issue “qualified school modernization bonds” in the form of tax credit bonds to fund the construction, rehabilitation or repair of public schools. \$11 billion of qualified school modernization bonds would be allocated among States and certain school districts in each of 2000 and 2001. Half of this annual cap would be allocated among the 100 school districts with the largest number of children living in poverty and up to 25 additional school districts that the Secretary of Education determines are in particular need of assistance. The other half of the cap would be allocated among States and Puerto Rico. A small portion of the total cap would be set aside for each U.S. possession (other than Puerto Rico) based on its share of the total U.S. poverty population. In addition, \$200 million in each year would be allocated by the Secretary of the Interior for the construction, rehabilitation, and repair of the Bureau of Indian Affairs-funded elementary and secondary schools. The allocation among qualifying school districts and among States would be based on the amounts of federal assistance received under the Basic Grant Formula for Title I of the Elementary and Secondary Education Act of 1965. This assistance is based primarily upon the number of low-income children residing in the district, with an adjustment for differences in per-pupil expenditures. States could use any appropriate mechanism for distributing their allocation among school districts, not necessarily the Title I formula. Allocated amounts unissued in the year of allocation could be issued up until the end of the third following year. A qualifying school district could transfer any unused portion of its allocation to the State in which it is located at any time prior to that date.

Under the proposal, a bond would be treated as a qualified school modernization bond if three requirements are met. First, the Department of Education must approve the school modernization plan of the State or eligible school district. The plan must (1) demonstrate that a comprehensive survey has been undertaken of the construction and renovation needs in the jurisdiction, and (2) describe how the jurisdiction will ensure that bond proceeds are used for the purposes of this proposal. Second, the issuing government must receive a bond allocation for a school modernization bond. Third, 95 percent or more of the bond proceeds must be used to construct, rehabilitate, or repair elementary and secondary public school facilities. Modernization plans for Bureau of Indian Affairs-funded schools would be approved by the Department of the Interior. The term construction

includes land upon which a constructed school facility is located. Unlike qualified zone academy bonds, qualified school modernization bonds would not be conditioned on contributions from private businesses.

#### Qualified zone academy bonds.

The proposal would provide authority for \$1 billion in 2000 and \$1.4 billion in 2001 of qualified zone academy bonds. The list of permissible uses of proceeds of qualified zone academy bonds would be expanded to include school construction. In addition, the proposal would make several changes to the existing qualified zone academy bond statute applicable to bonds issued after the effective date to conform to the structure of tax credit bonds described below.

#### Rules applicable to tax credit bonds generally.

The holder of a tax credit bond would receive annual Federal income tax credits equal to the applicable credit rate multiplied by the amount held on its anniversary date. Because the annual credits compensate the holder for lending money, they would be treated as payments of interest for Federal income tax purposes and, accordingly, would be included in the holder's gross income. The credit rate would be set equal to a measure of the yield on outstanding corporate bonds, specified in Treasury regulations, for the business day prior to the date of issue. The maximum term of the bonds would be 15 years. Any taxpayer would be able to hold a tax credit bond and thereby claim the tax credit. Treasury would provide regulations regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares. Unused credits would not be carried backward but would be carried forward for 5 years. The proposal would grant regulatory authority to the Secretary to require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Under the proposal, at least 95 percent of the tax credit bond proceeds must be used for qualifying purposes. Any investment earnings (and earnings on those earnings) associated with unexpended proceeds during the three-year period following the date of issuance are treated as proceeds, i.e., they must also be used for qualifying purposes. As of the date of issue, issuers must reasonably expect that 95 percent of the proceeds will be expended for qualifying purposes within three years and that any property financed with bond proceeds will be used for a qualified purpose for at least a 15-year period after the date of issuance. During the three-year period, unexpended proceeds may only be invested in bank accounts or U.S. Treasury securities maturing in three years or less. Issuers must incur a binding obligation with a third party to expend at least 10 percent of the proceeds of the issue within 6 months of the issue date and allocate the bond sale proceeds to expenditures with due diligence. To the extent 95 percent of proceeds are not expended by the end of the 3-year period for qualifying purposes, unexpended proceeds must be used to retire bonds within 90 days. If the issuer establishes a sinking fund to repay principal, sinking fund assets must be held in State and Local Government Securities (SLGS) issued by the Treasury. Property financed with the sale proceeds of qualified zone academy bonds or school modernization bonds must be owned by a State or local governmental unit or an agency thereof.

Bonds would cease to be qualified bonds and would accrue no further tax credits in the event that any of the tax-related requirements fail to be met. The issuer would be obligated to reimburse the Federal government (with interest) for any credits accruing three years prior to the date of non-compliance. If this obligation is not timely paid by the issuer, the Federal government has the right to recover the credit amount from the current holder of the bonds.

The proposal would be effective for bonds issued on or after January 1, 2000.

## **EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE**

### **Current Law**

Section 127 provides that an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to a qualified educational assistance program. This exclusion is limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applies whether or not the education is job-related. In the absence of this exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

The exclusion applies with respect to undergraduate courses beginning before June 1, 2000. The exclusion does not apply to graduate level courses beginning after June 30, 1996.

### **Reasons for Change**

Well-educated workers are essential to an economy experiencing technological change and facing global competition. Extension of section 127, including reinstatement of its application to graduate courses, will expand educational opportunity and increase productivity. In addition, these provisions will encourage the retraining of current and former employees to reflect the changing needs of the workplace. The extension of section 127 also will simplify the rules for employers and workers by eliminating the need to distinguish between job-related expenses and other employer-provided educational assistance.

### **Proposal**

The current-law exclusion would be extended by 18 months to apply to undergraduate courses beginning before January 1, 2002. In addition, the exclusion would be reinstated for graduate education, effective for courses beginning after June 30, 1999 and before January 1, 2002.

## **TAX CREDIT FOR EMPLOYER-PROVIDED WORKPLACE LITERACY AND BASIC EDUCATION PROGRAMS**

### **Current Law**

Workplace literacy and basic education expenses are deductible to employers, either as ordinary and necessary business expenses to the extent they are job-related or as employee compensation. If they are deemed to be compensation, the expenses are includable in the worker's gross income unless provided under a section 127 educational assistance plan or treated as a working condition fringe benefit. Under a section 127 plan, educational expenses other than for graduate education are excluded from an employee's gross income for income and employment tax purposes, up to \$5,250 per year. (Section 127 expires with respect to courses beginning after May 31, 2000.) Educational expenses paid by an employer outside of a section 127 plan that are related to the employee's current job may be excludable from the employee's gross income as a working condition fringe benefit, but not if the education relates to certain minimum educational requirements or enables the employee to begin working in a new trade or business.

No credits are allowed to employers for workplace literacy or other types of employee education expenses. Lifetime Learning tax credits may be available to employees for high school equivalency courses taken at postsecondary institutions such as community colleges.

### **Reasons for Change**

With the increasing technological level of the workplace of the 21<sup>st</sup> century, workers with low levels of education will fall farther behind their more educated coworkers and run greater risk of unemployment. However, low-skilled workers may not undertake needed education because they lack the time for the courses or the resources to overcome barriers such as cost, child care, and transportation. Their employers may hesitate to provide general education because the benefits of basic skills and literacy education are more difficult for employers to capture through increased productivity than the benefits of job-specific education. Providing a credit will encourage employers to provide workplace literacy and basic education programs to their employees.

### **Proposal**

Employers who provide certain workplace literacy, English literacy, and basic education programs for their eligible employees would be allowed to claim a credit against the employer's Federal income taxes. The amount of the credit would equal 10 percent of the employer's eligible expenses incurred with respect to qualified education programs, with a maximum credit of \$525 per participating employee. The credit would be treated as a component of the general business credit, and would be subject to the limitations of that credit.

Qualified education would be limited to (1) basic skills instruction at or below the level of a high school degree; and (2) English literacy instruction. Eligible employees -- employees with respect

to whom the employer could claim a credit -- would generally not have received a high school degree or its equivalent, or, for English literacy programs, would have limited English proficiency. The employer could claim a credit with respect to employees with high school degrees but who lack sufficient mastery of basic educational skills to function effectively in the workplace only if an eligible provider both assesses the educational level of the employees and provides the instructional program for the employer. Eligible employees must be citizens or resident aliens aged 18 or older who are employed by the taxpayer in the United States for at least six months.

To be eligible for the credit, the provision of literacy or basic education by an employer must meet the nondiscrimination requirements for educational assistance programs under current-law section 127. If expenses for a literacy or basic education program are eligible for the credit, then the educational benefits provided to employees under that program would be treated as tax-free working condition fringe benefits under section 132(d).

Expenses eligible for the credit would include payments to third parties and payments made directly to cover instructional costs, including but not limited to salaries of instructors, curriculum development, textbooks, and instructional technology used exclusively to support basic skills instruction. Wages paid to workers while they participate as students in the literacy or basic education program would not be eligible for the credit. The amount of the credit claimed reduces, dollar for dollar, the amount of education expenses that the employer may otherwise deduct in computing its taxable income.

Unless the employer provides basic skills instruction through an eligible provider, the curriculum must be approved by a State adult education authority, defined as an "eligible agency" in section 203(4) of the Adult Education and Family Literacy Act. An "eligible provider" would be an entity that is receiving Federal funding for adult education and literacy services or English literacy programs under the Adult Education and Family Literacy Act, Title II of the Workforce Investment Act of 1998. Eligible providers include local education agencies, certain community-based or volunteer literacy organizations, institutions of higher education, and other public or private nonprofit agencies.

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



## **ENCOURAGE CORPORATE SPONSORSHIP OF QUALIFIED ZONE ACADEMIES IN EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES**

### **Current Law**

Pursuant to the Omnibus Budget Reconciliation Act of 1993 and the Taxpayer Relief Act of 1997, 31 empowerment zones and 95 enterprise communities have been designated under section 1391 of the Internal Revenue Code. Designated empowerment zones and enterprise communities are required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations. Special tax incentives are available for certain businesses located in an empowerment zone or enterprise community.

Under current-law section 1397E, State and local governments can issue qualified zone academy bonds to fund improvements in certain “qualified zone academies” which provide elementary or secondary education. A total of \$400 million of qualified zone academy bonds may be issued in each of 1998 and 1999 (and unused authority to issue such bonds may be carried forward to subsequent years). The annual cap is allocated among the States in proportion to their populations of individuals with incomes below the poverty level. An eligible holder of a qualified zone academy bond receives annual Federal income tax credits, which compensate the holder for lending the money and, therefore, are treated like taxable interest payments for Federal income tax purposes. Qualified zone academies must be located in either a designated empowerment zone or enterprise community or, if not, there must be a reasonable expectation that at least 35 percent of the students attending the academy will be eligible for free or reduced-cost lunches under the National School Lunch Act.

### **Reasons for Change**

To encourage private-sector support of, and participation in, educational programs conducted at qualified zone academies located in empowerment zones and enterprise communities, a tax credit should be provided for certain corporate sponsorship payments made to qualified zone academies.

### **Proposal**

A credit against Federal income taxes would be allowed for certain corporate sponsorship payments made to a qualified zone academy located in a designated empowerment zone or enterprise community. The credit would equal 50 percent of cash contributions, plus 50 percent of the fair market value of certain in-kind contributions made to a qualified zone academy. For purposes of the credit, a qualified zone academy would be treated as located in a designated empowerment zone or enterprise community if a significant percentage of its students reside in the zone or community.

The credit would be available only if a credit allocation has been made with respect to the corporate sponsorship payment by the local governmental agency with responsibility for implementing the strategic plan of the empowerment zone or enterprise community under section 1391(f)(2), in

consultation with the local educational agency with jurisdiction over public schools in the zone or community. The local governmental agency for each of the 31 designated empowerment zones would be allowed to designate up to \$8 million of sponsorship payments to qualified zone academies as eligible for the 50-percent credit (that is, up to \$4 million of credits). The local governmental agency for each of the 95 designated enterprise communities would be allowed to designate up to \$2 million of contributions to qualified zone academies as eligible for the 50-percent credit (that is, up to \$1 million of credits). The deduction otherwise allowed for a corporate sponsorship payment would be reduced by the amount of the credit claimed with respect to such payment by the corporate sponsor. The proposed credit would be subject to the general business credit rules under present-law section 38, and would be effective for corporate sponsorship payments made after December 31, 1999.

## **ELIMINATE 60-MONTH LIMIT ON STUDENT LOAN INTEREST DEDUCTION**

### **Current Law**

Section 221, which was enacted in 1997, provides a deduction for certain interest paid on a qualified education loan during the first 60-months that interest payments are required on the loan, effective for interest due and paid after December 31, 1997. The maximum allowable deduction is \$1,000 in 1998, \$1,500 in 1999, \$2,000 in 2000 and \$2,500 in 2001 and subsequent years. The maximum deduction is not indexed for inflation. In addition, the deduction is phased out ratably for single taxpayers with adjusted gross income (AGI) between \$40,000 and \$55,000 and for married taxpayers filing a joint return with AGI between \$60,000 and \$75,000. The phase-out ranges are indexed for inflation beginning after 2002.

### **Reasons for Change**

The 60-month limitation under section 221 adds significant complexity and administrative burdens for taxpayers, lenders, loan servicing agencies and the IRS. For example, a taxpayer may have several student loans, which may have entered repayment status on different dates. In addition, special rules are required to apply the 60-month limitation in common situations, such as periods of loan deferment or forbearance, loan refinancings, and loan consolidations. The 60-month limitation could also lead to the inconsistent treatment of taxpayers based on how a lender structures the interest payments on a qualified education loan and when a taxpayer chooses to make interest payments. For example, a taxpayer who elects to capitalize interest that accrues on a qualified education loan while the taxpayer is enrolled in college (and the loan is in deferment) may be able to deduct more total interest payments than a taxpayer (with the same size qualified education loan) who elects to pay the interest currently during college. This is true because, in the former case, the 60-month period is suspended while the loan is in deferment; in the latter case, the 60-month period continues to elapse. Eliminating the 60-month limitation would simplify the calculation of deductible interest payments, avoid inconsistent treatment of taxpayers and also provide longer-term relief to taxpayers with large educational debt.

### **Proposal**

The proposal would eliminate the limit on the number of months during which interest paid on a qualified education loan is tax-deductible. The proposal generally would be effective for interest paid on qualified education loans after December 31, 1999.

## **ELIMINATING TAX ON FORGIVENESS OF DIRECT STUDENT LOANS SUBJECT TO INCOME CONTINGENT REPAYMENT**

### **Current Law**

Generally, when a lender forgives a borrower's loan, the borrower has income equal to the loan balance that is forgiven. In the case of student loans, an exception is provided when the lender is a governmental agency or tax-exempt charitable or educational organization, and the lender forgives all or part of the loan in return for the borrower's providing professional services for a certain period of time to certain employers for the benefit of the community.

Individuals who borrow money to pay for postsecondary education through the Federal government's Direct Loan program may elect income contingent repayment of their loans. If they elect income contingent repayment, the size of their repayment installments is adjusted in accordance with their income. If an individual who has elected income contingent repayment still has an outstanding loan balance after having been in income contingent repayment status for twenty-five years, the loan balance is forgiven.

### **Reasons for Change**

When taxpayers who have elected income contingent repayment qualify for loan forgiveness after having been in income contingent repayment status for twenty-five years, the taxpayers should be able to take advantage of the loan forgiveness without undertaking a substantial new obligation for income tax to the Federal government.

### **Proposal**

The proposal would allow a taxpayer to exclude from income any amount the taxpayer would otherwise include as a result of the forgiveness of a student loan made under the Direct Loan program.

The proposal would be effective for loan cancellations after December 31, 1999.

## **TAX TREATMENT OF EDUCATION AWARDS UNDER CERTAIN FEDERAL PROGRAMS**

### **1. Eliminate Tax on Awards under National Health Corps Scholarship Program and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program**

#### **Current Law**

Section 117 provides tax-free treatment for certain scholarship and fellowship grants used to pay qualified tuition and related expenses, but not to the extent that any grant represents compensation for services. The National Health Service Corps (NHSC) Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program provide certain education awards to participants on condition that the participants provide certain services. These education awards generally involve the payment of higher education expenses (under the NHSC program, the awards may be also used for the repayment or cancellation of existing or future student loans). Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

#### **Reasons for Change**

Imposing a tax liability on education awards under these Federal programs undercuts the objective of providing an incentive for health professionals to serve in medically underserved geographic areas, in the case of the NHSC Scholarship Program, or the Armed Forces, in the case of the Armed Forces Health Professions Program.

#### **Proposal**

The proposal would provide that amounts received by an individual under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program are “qualified scholarships” excludable from income, without regard to any service obligation by the recipient.

The proposal would be effective for education awards received after December 31, 1999.

## **2. Eliminate Tax on Repayment or Cancellation of Student Loans under NHSC Scholarship Program, Americorps Education Award Program, and Armed Forces Health Professions Loan Repayment Program**

### **Current Law**

Section 108(f) provides tax-free treatment for certain discharges of student loans which result from the debtor's agreeing to work for a certain period of time in certain professions for any of a broad class of employers. The NHSC Scholarship Program, the Americorps Education Award Program, and the Armed Forces Health Professions Loan Repayment Program provide education awards to participants that may be used for the repayment or cancellation of existing or future student loans. However, the repayment or cancellation of student loans under these programs appears not to meet the requirements for exclusion under current-law section 108(f).

### **Reasons for Change**

The tax liability on student loan repayments or cancellations under these Federal programs reduces the incentive for individuals to participate in these programs, which provide important health, education, and other services to underserved areas, in the case of the NHSC and Americorps programs, and maintain quality health services for the Armed Forces, in the case of the Armed Forces Health Professions Program.

### **Proposal**

The proposal would provide that any repayment or cancellation of a student loan under the NHSC Scholarship Program, the Americorps Education Award Program, or the Armed Forces Health Professions Loan Repayment Program is excludable from income. The tax-free treatment would apply only to the extent that the student incurred qualified tuition and related expenses in excess of those which were taken into account in determining the amount of any education credit claimed during academic periods when the student loans were incurred.<sup>6</sup>

The proposal would be effective for repayments or cancellations of student loans received after December 31, 1999.

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<sup>6</sup>For this purpose, qualified expenses were not taken into account to the extent that the otherwise allowable credit was reduced due to the taxpayer's AGI.

## **Making Child Care More Affordable**

### **INCREASE, EXPAND AND SIMPLIFY THE CHILD AND DEPENDENT CARE TAX CREDIT**

#### **Current Law**

A taxpayer may be eligible for a nonrefundable tax credit if he or she pays for the care of a qualifying individual in order to work. Qualifying individuals include dependents under the age of 13 and disabled dependents or spouses. The credit is equal to a percentage of the taxpayer's employment-related expenditures for child or dependent care. A taxpayer must provide over half the costs of maintaining the household in which the taxpayer and the qualifying dependent reside. Taxpayers who do not incur out-of-pocket child care expenses are not eligible for the credit.

The credit rate depends on the taxpayer's adjusted gross income. The credit rate is phased-down from 30 percent (for taxpayers with adjusted gross incomes of \$10,000 or less) to 20 percent (for taxpayers with adjusted gross incomes above \$28,000). The maximum amounts of qualifying employment-related expenses for which credits can be claimed are limited to \$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals. Thus, the maximum credit ranges from \$480 to \$720 for a taxpayer with one qualifying individual and \$960 to \$1,440 for a taxpayer with two or more qualifying individuals.

Employees may exclude from their taxable income (and their earnings for social security tax purposes) amounts their employers provide as child and dependent care benefits, including those provided through a cafeteria plan. The exclusion is limited to \$5,000 of child care expenses per year and does not vary with the number of qualifying dependents. The amount of a taxpayer's expenses eligible for the child and dependent care credit is reduced dollar for dollar by the amount of excludable benefits provided by the employer.

#### **Reasons for Change**

Many working parents cannot find affordable and safe child care. In the FY 2000 budget, the Administration is proposing a comprehensive initiative to address the child care needs of both low- and moderate-income working families. Low-income families will receive additional assistance through an expansion of the Child Care and Development Block Grant. The needs of moderate-income families can be best served through an expansion of the child and dependent care tax credit, which was last increased in 1982.

Infants require special care and attention. Infants especially benefit from bonding with their parents during their first year, although many parents cannot afford to stay at home to care for their children. To enable parents to make the best choices for caring for their youngest children, the child and dependent care tax credit should be expanded to provide additional assistance to taxpayers with infants.

## Proposal

### Expand basic child and dependent care credit

The maximum child and dependent care tax credit rate would be increased from 30 percent to 50 percent. Taxpayers would be eligible for the 50-percent credit rate if their adjusted gross income is \$30,000 or less. For taxpayers with adjusted gross incomes between \$30,000 and \$59,000, the credit rate would be reduced by one percentage point for each additional \$1,000, or fraction thereof, of adjusted gross income in excess of \$30,000. Taxpayers with adjusted gross incomes over \$59,000 would be eligible for a 20-percent credit rate. The current-law maximum amounts of employment-related expenses for which the credit can be claimed (\$2,400 for one qualifying individual and \$4,800 for two or more qualifying individuals) would be retained. Thus, the maximum credit would range from \$480 to \$1,200 for a taxpayer with one qualifying individual and \$960 to \$2,400 for a taxpayer with two or more qualifying individuals.

Taxpayers generally would no longer be required to provide over half the costs of maintaining the home in which the taxpayer and the qualifying individual reside to claim the child and dependent care tax credit, but would still be required to demonstrate that they resided in the same household as the qualifying individual. A married taxpayer who files a separate return, however, would still have to meet the current law household maintenance test in order to qualify for the credit.

The provision would be effective for tax years beginning after December 31, 1999. Beginning 2001, the \$30,000 starting point for the phase-down range would be indexed for inflation. The maximum amounts of qualifying child and dependent care expenses that could be claimed for the credit also would be indexed, beginning in 2001.

### Additional credit for taxpayers with infants

The child and dependent care tax credit would be expanded to provide an additional credit for all taxpayers with qualifying dependents under the age of one (“infants”), whether or not they incur out-of-pocket child care expenses. The additional credit amount would be equal to the applicable credit rate multiplied by \$500 for an infant (\$1,000 for two or more infants).

For taxpayers with infants who incur out-of-pocket child care expenses in order to work, the proposed expanded basic child and dependent care tax credit would be augmented by allowing these taxpayers to add \$500 (or \$1,000 if two or more infants) to these expenses. For example, a two-earner couple with an infant could qualify for a maximum child and dependent care tax credit of up to \$1,450 if they incurred \$2,400 or more of out-of-pocket child care expenses (50 percent x (\$2,400+\$500)).

Taxpayers with infants who do not incur any out-of-pocket child care expenses would also be eligible for the additional credit for infants. For example, a taxpayer with a stay-at-home spouse who cares for their infant would qualify for a maximum credit of up to \$250 (50 percent x \$500)



(\$500 if they have two or more infants). Similarly, a two-earner couple with an infant could qualify for a credit of up to \$250 even if they rely on unpaid relatives and friends to help care for their infant while they are at work.

The provision would be effective for taxable years beginning after December 31, 1999. The additional credit for taxpayers with infants would be appropriately indexed for inflation beginning in 2000.

## **PROVIDE TAX INCENTIVES FOR EMPLOYER-PROVIDED CHILD-CARE FACILITIES**

### **Current Law**

If an employer incurs expenses to assist employees in obtaining child care, either by acquiring or constructing a child care facility for their use or arranging for third parties to provide child care services, those expenses generally are either immediately deductible under section 162 as ordinary and necessary business expenses or capitalized and then recovered over time through depreciation deductions. Employers may also treat up to \$5,000 per year in dependent care assistance provided to an employee who is a long-term family assistance recipient as wages for purposes of the Welfare-to-Work Tax Credit provided under section 51A. Otherwise, an employer is not eligible to take a credit against Federal income tax for expenses incurred that relate to child care for its employees.

### **Reasons for Change**

As part of the Administration's comprehensive initiative to address the child care needs of both low- and moderate-income working families, the Administration intends to provide private sector employers with an incentive to make quality child care services available to their employees.

### **Proposal**

Taxpayers would receive a credit against their Federal income tax equal to 25 percent of qualified expenses for employee child care. These expenses would include costs incurred:

- (1) to acquire, construct, rehabilitate or expand property that is to be used as part of a taxpayer's qualified child care facility;
- (2) for the operation of a taxpayer's qualified child care facility, including the costs of training and continuing education for employees of the child care facility; or
- (3) under a contract with a qualified child care facility to provide child care services to employees of the taxpayer.

To be a qualified child care facility, the principal use of the facility must be for child care, and the facility must be duly licensed by the State agency with jurisdiction over its operations. Also, if the facility is owned or operated by the taxpayer, at least 30 percent of the children enrolled in the center (based on an annual average of the enrollment measured at the beginning of each month) must be children of the taxpayer's employees. If a taxpayer opens a new facility, it must meet the 30 percent employee enrollment requirement within two years of commencing operations. If a new facility failed to meet this requirement, the credit would be subject to recapture.

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

A taxpayer would also be entitled to a credit for ten percent of expenses incurred to provide employees with child care resource and referral services.

A taxpayer's total credit under this proposal would be limited to \$150,000 per year. Any deduction the taxpayer would otherwise be entitled to take for the qualified expenses would be reduced by the amount of the credit. Similarly, if the credit is taken for expenses of acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility would be reduced by the amount of the credit. The credit would be subject to the general business credit rules of section 38.

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

## **Provide Incentives To Revitalize Communities**

### **INCREASE LOW-INCOME HOUSING TAX CREDIT PER CAPITA CAP**

#### **Current Law**

A tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed or substantially rehabilitated residential units. In order for a credit to be claimed with respect to a building, the building owner must receive a credit allocation from a State or local housing authority. The low-income housing credit is allocated by State or local government authorities subject to an annual limitation for each State. The annual State housing credit limitation, expressed in terms of first-year credits, is currently equal to the sum of \$1.25 per capita, the amount of unused housing credit (if any) for the preceding calendar year, the amount of housing credits (if any) returned to the State or local authority in the calendar year, and the housing credit amounts (if any) allocated to such State by the Secretary of the Treasury out of a pool of returned credits. The \$1.25 per capita amount, used in determining a State's total amount of available first-year credits, was set in 1986.

#### **Reasons for Change**

The need for decent low-income housing exceeds the amount markets provide at affordable rents. Most State agencies receive qualified proposals for far more low-income rental housing than they can support with available credits. Without the tax credits, these projects will not be undertaken. A modest increase in the per capita amount will allow additional low-income housing to be provided but still will require that State agencies choose projects that meet specific housing needs.

#### **Proposal**

The annual State low-income housing credit limitation would be increased to \$1.75 per capita, effective for calendar years beginning after 1999.

## **PROVIDE TAX CREDITS FOR HOLDERS OF BETTER AMERICA BONDS**

### **Current Law**

State and local governments may issue tax-exempt bonds without limit for environmental purposes so long as no more than 10 percent of the bond proceeds are: 1) used by private entities in a trade or business and payments or security associated with that use are available to pay interest and principal on the bonds, and 2) no more than 5 percent of the bond proceeds are lent to private businesses or individuals. If these private activity tests are met, tax-exempt private activity bonds may nonetheless be issued, subject to State-by-State volume caps, for the following environmental purposes: water, sewage, solid waste disposal facilities, hazardous waste facilities, environmental enhancements of hydro-electric generating facilities and redevelopment infrastructure in blighted areas if the bonds are supported by incremental property taxes. The federal subsidy indirectly provided by tax-exempt bonds is limited by market forces to the differential in interest rates between tax-exempt bonds and taxable bonds of similar risk and maturity. Deeper subsidies are provided to Qualified Zone Academy Bonds, the entire interest on which is paid in the form of tax credits.

Taxpayers are allowed to expense, rather than capitalize or amortize, certain environmental remediation costs with respect to certain areas referred to as brownfields.

### **Reasons for Change**

Significant public benefits are provided by protecting open spaces; creating forest preserves near urban areas; rehabilitating land that has been degraded by toxic or other wastes or destruction of its ground cover; improving parks and reestablishing wet lands. These benefits include creating more livable urban, suburban, and rural environments, protecting public health, repairing environmental damage and, in the case of reforestation, absorbing greenhouse gases. Local governments are typically unwilling to assume the major financial burdens required to take the actions necessary to secure these benefits because the benefits are so widely diffused. Tax-exempt bond financing may not provide a deep enough subsidy to induce State and local governments to undertake beneficial environmental infrastructure projects. Moreover, the expensing provision does not provide an incentive for environmental remediation of property owned by governments and intended for future public use or for use by a tax-exempt entity.

### **Proposal**

State and local governments (including Native American tribal governments and U.S. Possessions) would be able to issue Better America Bonds (BABs) to the extent of authority to do so allocated by the Administrator of the Environmental Protection Agency (EPA). The volume of authority to issue BABs that may be allocated by the EPA Administrator in each of the five years, beginning in 2000, would be \$1.9 billion. Amounts unallocated for any year may be allocated in the

following year. Allocated amounts unissued in the year of allocation may be issued up until the end of the third following year.

As part of an annual competition, States (including Native American Tribal governments and U.S. possessions), and local governments could apply to the EPA for authority to issue BABs. Applications would be submitted following guidelines which EPA would publish prior to January 1, 2000. Those guidelines would indicate the criteria to be used for approving applications. EPA, in consultation with other federal agencies, would review applications and award bond allocations in conjunction with the Community Empowerment Board. A government could issue BABs under an agreement with the sponsor of an approved application. Issuers would be responsible for repayment of principal to the holders of BABs upon their maturity.

The structure of BABs as tax credit bonds would be identical to that proposed for Qualified School Modernization Bonds and Qualified Zone Academy Bonds. The holder of a tax credit bond would receive annual federal income tax credits equal to the applicable credit rate multiplied by the amount held on its anniversary date. Because the annual credits compensate the holder for lending money, they would be treated as payments of interest for federal income tax purposes, and accordingly would be included in the holder's gross income. The credit rate would be set equal to a measure of the yield on outstanding corporate bonds, specified in Treasury regulations, for the business day prior to the date of issue. The maximum term of the bonds would be 15 years. Any taxpayer would be able to hold a tax credit bond and thereby claim the tax credit. Treasury would provide regulations regarding the treatment of credits that flow through from a mutual fund to the holder of mutual fund shares. Unused credits could be carried forward for 5 years. The proposal would require information returns to be provided with respect to holders (including corporations) that are entitled to credits.

Issuers must reasonably expect, as of the date of issue, that 95 percent of the proceeds will be expended for qualifying purposes within three years and that any property financed with bond proceeds will be used for a qualified purpose for at least a 15-year period after the date of issuance. For purposes of the requirement that 95 percent of tax credit bond proceeds be used for qualifying purposes, any investment earnings (and earnings on those earnings) associated with unexpended proceeds during the three-year period following the date of issuance are treated as proceeds, i.e., they must also be used for qualifying purposes. During the three-year period, unexpended proceeds may only be invested in bank accounts or U.S. Treasury securities maturing in three years or less. If the issuer establishes a sinking fund to repay principal, sinking fund assets must be held in State and Local Government Securities (SLGS) issued by the Treasury. Issuers must incur a binding obligation with a third party to expend at least 10 percent of the proceeds of the issue within 6 months of the issue date and allocate the sale proceeds to expenditures with due diligence. If 95 percent of proceeds are not expended by the end of the three-year period for qualifying purposes, unexpended proceeds must be used to retire a portion of the bonds within 90 days. No depreciation deductions would be allowed with respect to property financed with tax credit bonds.

Acquisition of land and facilities is only a qualifying purpose if the property is intended to be available, and is in fact reasonably available, for use by members of the general public. Any agreement, other than a management contract that would be a qualified management contract if the land or facilities had been financed with tax-exempt bonds, conveying priority rights or other preferential benefits to a private person violates the general public use provision and would not constitute a qualified purpose. Furthermore, repayment of principal may not be secured or paid with monies derived from private persons in any capacity other than that of the general public.

Bonds would cease to be qualified bonds and would accrue no further tax credits after the date the use of any bond-financed facilities changes to a non-qualifying use. The issuer would be obligated to reimburse the federal government (with interest) for any credits accruing prior to that date. If this obligation is not timely paid by the issuer, the federal government has the right to recover the credit amount from the current holder of the bonds. In the event the issuer fails to satisfy one of the other tax-related requirements, no further tax credits would accrue and the issuer would be obligated to reimburse the federal government (with interest) for all past credits claimed with respect to the bonds. In the event this obligation is not timely paid by the issuer, the federal government has the right to recover the credit amount from current bond holders.

The qualifying purposes for BABs are:

- a. Acquisition of land for open space, wetlands, public parks or greenways to be owned by an eligible issuer or by a 501(c)(3) entity whose exempt purpose includes environmental preservation.
- b. Construction of visitor facilities, such as campgrounds and hiking or biking trails, in connection with such acquired land or other open space, wetlands, or parks that are owned by an eligible issuer or by a 501(c)(3) entity whose exempt purpose includes environmental preservation.
- c. Remediation of land acquired under (a) above or of publicly owned open space, wetlands or parks (for example, for enhancing water quality) by planting trees or other vegetation, creating settling ponds to control runoff, undertaking reasonable measures to control erosion or protect endangered species, and remediating conditions caused by the prior disposal of toxic or other waste.
- d. Acquisition of easements on privately owned open land that prevent commercial development and any substantial change in the use or character of the land. Such easements must be in a form which, if contributed by the owner of the open land, would qualify under section 170(h).
- e. Environmental assessment and remediation of contaminated property -- brownfields -- owned by State or local governments because it was abandoned by the prior owner, e.g., for non-payment of taxes. The property would have to be an area at or on which there has been

a release (or threat of release) or disposal of any hazardous substance within the meaning of section 198. For this use, and this use only, private use (by an entity which is not a 501(c)(3) entity) of proceeds as well as private payment of bond principal is permitted. For example, the cost of environmental remediation of such property could be financed with BABs and the land subsequently sold to a private entity with the proceeds of the sale used to repay principal through the use of a sinking fund. The federal government would not be a qualifying private entity. No expenditures financed with BAB proceeds would be eligible for expensing under section 198.

To encourage continuing use of property financed with BABs, such property could not be converted to a non-qualifying use after the expiration of the 15-year compliance period without a reasonable amount of time being allowed for any 501(c)(3) entity whose exempt purpose includes environmental protection to exercise an option, granted upon issuance of the bonds and recorded in property records, to purchase the property at the price originally paid in conjunction with the expenditure of bond proceeds so long as the purchasing entity covenanted to retain the property in a qualifying use in perpetuity.

Issuance of BABs would be subject to the public approval rules of section 147(f). BABs could be issued in a pool bond format so long as the 3-year spend-out rule was observed.

The proposal would be effective for bonds issued on or after January 1, 2000.



## **PROVIDE NEW MARKETS TAX CREDIT**

### **Current Law**

In general, there are limited tax incentives for investing and making loans to businesses in low-income communities. For example, current law provides for targeted tax incentives that are intended to encourage investment in specialized small business investment companies that are licensed by the Small Business Administration to make loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

### **Reasons for Change**

Businesses in our nation's inner cities and isolated rural communities often lack access to equity capital to grow and succeed. To help attract new capital to these businesses, a new tax credit for equity investments in these businesses is proposed.

### **Proposal**

In general.--Taxpayers would be allowed a credit against Federal income taxes for qualified investments made to acquire stock or other equity interests in a selected community development entity. The credits would be allocated to selected community development entities by the Department of Treasury, pursuant to regulations to be issued by that Department. For each year during the period 2000-2004, the Treasury Department would be permitted to authorize selected community development entities to issue an aggregate of \$1.2 billion of equity interests with respect to which credits could be claimed under the proposal (a total of \$6 billion of new equity investment). If the selected community development entity fails to sell equity interests to investors up to the amount authorized within five years of the authorization, then the remaining authorization would be canceled, and the Treasury Department would have up to two years to authorize another community development entity to issue equity interests for the unused portion.

The credit allowed to the investor (either the original purchaser or a subsequent holder) would be a six-percent credit for each year during the five-year period after the equity interest is purchased from the selected community development entity. A taxpayer holding a qualified investment would be entitled to a credit on each credit allowance date (meaning each one-year anniversary, during a five-year period, of the date the investment was originally purchased from the community development entity). The taxpayer's basis in the investment would be reduced by the amount of the credit. The credit would be subject to the general business credit rules.

Qualified investments.--"Qualified investments" which entitle the investor to a credit must be common stock or other similar equity interest acquired from a selected community development entity

in exchange for cash.<sup>7</sup> The stock or other equity interest must not be redeemed (or otherwise cashed out) by the selected community development entity for at least five years. Substantially all of the proceeds of the investment must be used by the community development entity to make “qualified low-income community investments,” meaning equity investments in, or loans to, qualified active businesses located in low-income communities.<sup>8</sup> Qualified low-income community investments could be made directly by a selected community development entity, or could be made indirectly through another community development entity.<sup>9</sup>

Community development entities.--“Community development entities” that could apply for credit allocations would include (but would not be limited to) Community Development Financial Institutions, Community Development Corporations, Small Business Investment Corporations-LMIs, New Market Venture Capital Firms, America’s Private Investment Corporations, or other investment funds (including for-profit subsidiaries of nonprofit organizations). To be selected for a credit allocation, the community development entity’s primary mission must be serving or providing investment capital for low-income communities or low-income persons, the entity must maintain accountability to residents of low-income communities (through representation on governing or advisory boards, or otherwise), and at least 60 percent of the aggregate gross assets of the entity must be invested in “qualified low-income community investments” or residential property located in low-income communities.<sup>10</sup>

As part of the credit allocation process, the Treasury Department would certify entities as eligible “community development entities.” Certified entities would be required to file annual reports

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<sup>7</sup> To ensure that credits are available only for new equity investments in selected community development entities, the term “qualified investment” would not include any stock or other equity interest acquired from a community development entity which made a substantial stock redemption or distribution (without a bona fide business purpose therefor) in an attempt to avoid the purposes of the proposal.

<sup>8</sup> If at least 85 percent of the aggregate gross assets of the community development entity are invested (directly or indirectly) in equity interests in, or loans to, qualified active businesses located in low-income communities, then there would be no need to trace the use of the proceeds from the particular stock (or other equity ownership) issuance with respect to which the credit is claimed.

<sup>9</sup> A community development entity would be treated as indirectly making “qualified low-income community investment” when it purchases loans previously made by another community development entity which, in turn, uses the proceeds from the transaction to provide additional capital to qualified active businesses located in low-income communities.

<sup>10</sup> Expenditures made by a community development entity to provide financial counseling and certain other services to businesses located in, and residents of, low-income communities would also be treated as “qualified low-income community investment.”

demonstrating that they continue to meet all the requirements for initial certification, and would be required to identify the amount (and purchasers) of equity interests with respect to which allocated credits may be claimed by the purchaser and to demonstrate that the entity monitors its investments to ensure that capital is used in low-income communities.

If an entity fails to be a community development entity during the five-year period following the taxpayer's purchase of an equity interest in the entity, or if the equity interest is redeemed by the issuing entity during that five-year period, then any credits claimed with respect to the equity interest would be recaptured and no further credits would be allowed.

Low-income communities.--For purpose of the credit, "low-income communities" would be defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) median family income which does not exceed 80 percent of metropolitan area income (or for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income).

Qualified active businesses.--"Qualified active businesses" generally would be defined as businesses<sup>11</sup> which meet the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in low-income communities; (2) a substantial portion of the use of the tangible property of such business is used within low-income communities; (3) a substantial portion of the services performed for such business by its employees are performed in low-income communities; and (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property (e.g., debt, stock, partnership interests, options, futures contracts) or to collectibles (other than collectibles held primarily for sale to customers).

For purposes of the credit, there would be no requirement that employees of a "qualified active business" be residents of the low-income community. Rental of improved commercial real estate located in a low-income community (e.g., an office building or shopping mall) would be a qualified active business, regardless of the characteristics of the commercial tenants of the property. In addition, a qualified active business that receives a loan from a community development entity could include an organization that is organized and operated on a non-profit basis. The purchase and holding of unimproved real estate would not be a qualified active business. In addition, a qualified active business would not include (a) any business consisting predominantly of the development or holding of intangibles for sale or license; (b) operation of any facility described in sec. 144(c)(6)(B) (e.g., commercial golf course, country club, massage parlor, hot tub facility, suntan facility, liquor store); or (c) any business if a significant equity interest in such business is held by a person who also holds a significant equity interest in the community development entity.

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<sup>11</sup> As under current-law section 1394(b)(3)(D), the term "qualified active business" would include any trade or business which would qualify as such a business if the trade or business were separately incorporated.

Regulatory authority.--The Treasury Department would be granted authority to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal, including regulations limiting the benefit of the proposed tax credit in circumstances where investments are directly or indirectly being subsidized by other Federal programs (e.g., low-income housing credit and tax-exempt bonds), and regulations preventing abuse of the credit through the use of related parties. The Treasury Department would issue regulations describing the certification process for community development entities, annual reporting requirements for such entities, and application of the low-income community investment requirements to start-up entities.

Effective date.--The proposal would be effective for qualified investments made after December 31, 1999.

## **SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY TAX INCENTIVES**

### **Current Law**

Certain existing tax incentives are intended to encourage investment in specialized small business investment companies (“SSBICs”). SSBICs are partnerships or corporations that are licensed by the Small Business Administration to make long-term loans to, or equity investments in, small businesses owned by persons who are socially or economically disadvantaged.

One such incentive allows any C corporation or individual to elect to roll over without payment of tax any capital gains realized upon the sale of publicly-traded securities where the corporation or individual uses the proceeds from the sale to purchase common stock or a partnership interest in a SSBIC within 60 days of the sale of the securities. The amount of gain that an individual may elect to roll over under this provision for a taxable year is limited to the lesser of (1) \$50,000 or (2) \$500,000 reduced by the gain previously excluded under this provision. For corporations, these limits are \$250,000 annually and \$1,000,000 cumulatively.

Another incentive provides favorable qualification requirements, relative to other small businesses, for purposes of section 1202. Under section 1202, 50 percent of the gain realized by an individual upon the sale of qualifying small business stock is excluded from income. In order to be qualified, the small business must be engaged in an active business. The incentive provides that a SSBIC automatically is deemed to satisfy the active business requirement.

Certain regulated investment companies are entitled to deduct dividends paid to shareholders. To qualify for this favorable tax treatment, which effectively eliminates some or all of the tax on corporate earnings that would otherwise be imposed at the corporate level, the regulated investment company must meet certain requirements. These include a requirement that 90 percent of the company’s gross income be derived from dividends, interest, and other specified categories of passive income, a requirement that the company currently distribute 90 percent of its income in certain categories, and a requirement that at least 50 percent of the value of the company’s assets be adequately diversified in accordance with rules specifying the amount of investment in the securities of specific issuers.

### **Reasons for Change**

Additional tax incentives would further encourage investment in SSBICs, thereby increasing the amount of equity capital available to small businesses owned by persons who are socially or economically disadvantaged.

## **Proposal**

The proposal expands the tax-free rollover incentive in several ways. First, the 60-day rollover period is extended to 180 days. Second, a taxpayer who uses the proceeds of the sale of publicly-traded securities to purchase preferred stock in the SSBIC is also eligible for the exclusion. Third, the proposal increases the lifetime cap on the SSBIC rollover gain exclusion from \$500,000 to \$750,000 in the case of an individual, and from \$1,000,000 to \$2,000,000 in the case of a corporation. The annual caps on gain exclusion of \$50,000 per individual and \$250,000 per corporation are eliminated.

The proposal also provides that a SSBIC that is organized as a corporation may convert to a partnership within 180 days of enactment, without giving rise to tax at either the corporate or shareholder levels (although the shareholders would be taxed on gain to the extent of boot received in addition to partnership interests). To qualify for this treatment, the corporation must first distribute all of its accumulated earnings and profits (as taxable dividends), then contribute its assets to a partnership (in which it holds an interest of at least 80-percent immediately after the contribution), distribute the partnership interests to its shareholders, and immediately liquidate. The shareholders' basis in the partnership interests generally would carry over from their basis in the SSBIC stock. The partnership would remain subject to an entity-level tax immediately upon ceasing activity as a SSBIC or at any time that it disposes of assets that were held at the time of conversion on the amount of "built-in" gains inherent in such assets at the time of conversion.

The proposal relaxes several of the requirements for a SSBIC's qualification as a regulated investment company. First, income derived by a SSBIC from its limited partner interest in a partnership whose normal business operations the SSBIC does not actively manage will be treated as passive income which counts toward satisfaction of the 90 percent qualifying income test. Second, a SSBIC will be deemed to satisfy the 90 percent distribution requirement if it distributes all of the income that it is permitted to distribute under the Small Business Investment Act of 1958 (as in effect on May 13, 1993). Third, the SSBIC will be deemed to satisfy the diversification of assets requirement to the extent that its investments are permitted to a SSBIC under the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

In the case of a direct or indirect sale of SSBIC stock that qualifies for treatment under section 1202, the proposal raises the exclusion of gain from 50-percent to 60-percent.

A SSBIC would be defined as any partnership or corporation which is licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

The tax-free rollover and section 1202 provisions are effective for sales occurring after the date of enactment. The regulated investment company provisions are effective for taxable years beginning on or after the date of enactment.

## **EXTEND WAGE CREDIT FOR TWO NEW EMPOWERMENT ZONES**

### **Current Law**

The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) authorized a Federal demonstration project in which nine empowerment zones and 95 enterprise communities would be designated in a competitive application process. Of the nine empowerment zones, six were to be located in urban areas and three were to be located in rural areas. State and local governments would nominate distressed areas and propose strategic plans to stimulate economic and social revitalization.

Among other benefits, businesses located in the nine original empowerment zones are eligible for three Federal tax incentives: a wage credit; an additional \$20,000 per year of section 179 expensing; and a new category of tax-exempt private activity bonds. Businesses located in enterprise communities are eligible for the new category of tax-exempt bonds. OBRA '93 also provided that Federal grants would be made to designated areas.

The Taxpayer Relief Act of 1997 authorized the designation of two additional empowerment zones located in urban areas (the "additional empowerment zones") which generally are eligible for the same tax incentives as are available within the empowerment zones authorized by OBRA '93. The two additional empowerment zones, which have now been designated, are located in Cleveland, Ohio and Los Angeles, California. The tax incentives provided for these new zones take effect on January 1, 2000 and generally remain in effect for 10 years. The wage credit, however, is phased down beginning in 2005 and expires after 2007.

### **Reasons for Change**

The Administration believes that the availability of the tax incentives for the two additional empowerment zones should be expanded in order to help combat the pervasive poverty, and to stimulate the revitalization, of these areas.

### **Proposal**

The proposal would provide that the wage credit would remain in effect for a 10-year period from that date and would be phased down using the same percentages that apply to the original empowerment zones designated under OBRA '93.

The proposal would be effective as of January 1, 2000.

## **Promote Energy Efficiency and Improve the Environment**

### **PROVIDE TAX CREDIT FOR ENERGY-EFFICIENT BUILDING EQUIPMENT**

#### **Current Law**

No income tax credit is provided currently for investment in energy-efficient building equipment.

#### **Reasons for Change**

A credit for types of building equipment that are substantially more energy efficient than conventional equipment will help to accelerate the development and distribution of energy-efficient technologies. A credit would reduce costs to consumers, increasing demand for the equipment and reducing manufacturing costs, while also spurring technological innovation and reducing energy consumption.

#### **Proposal**

A credit of 10 percent of the purchase price (up to a maximum of \$250 per unit) would be allowed for the purchase after December 31, 1999 and before January 1, 2002 of the following building equipment:

Electric heat pumps (equipment using electrically powered vapor compression cycles to extract heat from air in one space and deliver it to air in another space) with a heating efficiency of at least 9 HSPF (Heating Seasonal Performance Factor) and a cooling efficiency of at least 13.5 SEER (Seasonal Energy Efficiency Rating).

Central air conditioners with an efficiency of at least 13.5 SEER.

Advanced natural gas water heaters (equipment using a variety of mechanisms to increase steady-state efficiency and reduce standby and vent losses) with an Energy Factor of at least 0.65 in the standard Department of Energy (DOE) test procedure.

A credit of 20 percent of the purchase price would be allowed for the purchase after December 31, 1999 and before January 1, 2004 of the following building equipment:

Fuel cells (equipment using an electrochemical process to generate electricity and heat) with an electricity-only generation efficiency of at least 35 percent and a minimum generating capacity of 5 kilowatts. The maximum credit would be \$500 per kilowatt of capacity.

Electric heat pump hot water heaters (equipment using electrically powered vapor compression cycles to extract heat from air and deliver it to a hot water storage tank) with



an Energy Factor of at least 1.7 in the standard DOE test procedure. The maximum credit would be \$500 per unit.

Electric heat pumps with a heating efficiency of at least 9 HSPF and a cooling efficiency of at least 15 SEER. The maximum credit would be \$500 per unit.

Central air conditioners with an efficiency of at least 15 SEER. The maximum credit would be \$500 per unit.

Advanced natural gas water heaters with an Energy Factor of at least 0.80 in the standard DOE test procedure. The maximum credit would be \$500 per unit.

Natural gas heat pumps (equipment using either a gas-absorption cycle or a gas-driven engine to power the vapor compression cycle to extract heat from one source and deliver it to another) with a coefficient of performance for heating of at least 1.25 and for cooling of at least 0.70. The maximum credit would be \$1,000 per unit.

A credit would be allowed only for final purchases from unrelated third parties. The credit would be nonrefundable. Credits for equipment used for business purposes would be subject to the limitations on the general business credit and would reduce the basis of the equipment.

## **TAX CREDIT FOR PURCHASE OF ENERGY EFFICIENT NEW HOMES**

### **Current law**

No deductions or credits are provided currently for the purchase of energy-efficient new homes.

### **Reasons for change**

Residences, which account for about one-sixth of all U.S. greenhouse gases, offer one of the largest single sources of carbon saving potential. Some States and certain Federal programs require new houses to meet Model Energy Code standards for insulation and related construction standards, and for heating, cooling and hot water equipment. By the use of cost-effective means, many new homes could reduce energy consumption by 30 to 50 percent or more compared to the standards in the Model Energy Code or the more recent 1998 International Energy Conservation Code (IECC). A targeted credit for such highly energy-efficient new housing could increase the use of energy-efficient building practices and efficient heating and cooling equipment. In addition, it may help spur innovation in the ways that houses are designed and built, thereby providing significant energy-saving and environmental benefits over the long term.

### **Proposal**

A tax credit of up to \$2,000 would be available to purchasers of highly energy-efficient new homes that meet energy-efficiency standards for heating, cooling and hot water that significantly exceed those of the IECC. A taxpayer may claim the credit only if the new home is the taxpayer's principal residence and reduces energy use by prescribed amounts as compared to the IECC for single family residences. The tax credit would be \$1,000 for new homes that are at least 30 percent more energy efficient than the IECC standard, and that are purchased in the two-year period beginning January 1, 2000 and ending December 31, 2001. The tax credit would be \$1,500 for new homes that are at least 40 percent more energy efficient than the IECC standard, and purchased in the three-year period beginning January 1, 2000 and ending December 31, 2002. The tax credit would be \$2,000 for new homes that are at least 50 percent more energy efficient than the IECC standard, and purchased in the five-year period beginning January 1, 2000 and ending December 31, 2004.

## **EXTEND TAX CREDIT FOR ELECTRIC VEHICLES AND PROVIDE TAX CREDIT FOR CERTAIN FUEL-EFFICIENT HYBRID VEHICLES**

### **Current Law**

No generally available income tax credit for purchases of fuel-efficient vehicles is provided currently. A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of \$4,000. A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electric current, the original use of which commences with the taxpayer, and that is acquired for use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit begins to phase down in 2002 and does not apply to vehicles placed in service after 2004.

Certain costs of qualified clean-fuel vehicle property may be deducted when such property is placed in service. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction begins to phase down in 2002 and does not apply to property placed in service after 2004.

### **Reasons for Change**

The transportation sector now accounts for one-third of greenhouse gas emissions in the United States. Cars, sport utility vehicles, light trucks and minivans alone account for 20 percent of our greenhouse gas emissions.

The proposed credits will encourage the early introduction and purchase of vehicles that incorporate new fuel-efficient technologies and will help to move ultra fuel-efficient vehicles with two or three times the fuel efficiency of today's vehicles from the laboratory to the highway. These vehicles can significantly reduce emissions of carbon dioxide, the most prevalent greenhouse gas.

### **Proposal**

The proposal would extend the present credit for qualified electric vehicles and provide temporary tax credits for fuel-efficient hybrid vehicles:

- (1) Credit for electric vehicles. The phase down of the credit for electric vehicles would be eliminated and the credit would be extended through 2006. Thus, the maximum \$4,000 credit would be available for purchases before 2007.
- (2) Credit for fuel-efficient hybrid vehicles. The credit would be: (a) \$1,000 for each vehicle that is one-third more fuel efficient than a comparable vehicle in its class, effective for purchases of qualifying vehicles after December 31, 2002 and before January 1, 2005; (b) \$2,000 for each vehicle that is two-thirds more fuel efficient than a comparable vehicle in its

class, effective for purchases of qualifying vehicles after December 31, 2002 and before January 1, 2007; (c) \$3,000 for each vehicle that is twice as fuel efficient as a comparable vehicle in its class, effective for purchases of qualifying vehicles after December 31, 2003 and before January 1, 2007; and (d) \$4,000 for each vehicle that is three times as fuel efficient as a comparable vehicle in its class, effective for purchases of qualifying vehicles after December 31, 2003 and before January 1, 2007.

A qualifying hybrid vehicle would be a vehicle powered by onboard fuel which uses regenerative braking and an energy storage system that will recover at least 60 percent of the energy in a typical 70-0 braking event. A qualifying vehicle would have to meet all emission requirements applicable to gasoline-powered automobiles.

These credits would be available for all qualifying light vehicles including cars, minivans, sport utility vehicles, and light trucks. Taxpayers who claim one of these credits would not be able to claim the qualified electric vehicle credit or the deduction for clean-fuel vehicle property for the same vehicle.

## **INVESTMENT TAX CREDIT FOR COMBINED HEAT AND POWER (CHP) SYSTEMS**

### **Current law**

Combined heat and power (CHP) systems are used to produce electricity (and/or mechanical power) and usable thermal energy from a single primary energy source. Depreciation allowances for CHP property vary by asset use and capacity. Assets employed in the production of electricity used by the taxpayer in an industrial manufacturing process or plant activity (and not ordinarily available for sale to others) have a general cost recovery period of 15 years if rated with total capacity in excess of 500 kilowatts. Electricity production assets of lesser rated capacity generally are classified with other manufacturing assets and have cost recovery periods of five to ten years. Assets used in the production of electricity for sale have either a 15-year or 20-year recovery period. For assets that are structural components of buildings, however, the recovery period is either 39 years (if nonresidential) or 27.5 years (if residential), and the straight-line method for computing depreciation allowances must be used. For assets with recovery periods of 10 years or less, the 200 percent declining balance method may be used to compute depreciation allowances. The 150 percent declining balance method may be used for assets with recovery periods of 15 or 20 years.

### **Reasons for change**

Combined heat and power systems utilize thermal energy that is otherwise wasted in producing electricity by more conventional methods. CHP systems achieve a greater level of overall energy efficiency, and thereby lessen the consumption of primary fossil fuels, lower total energy costs, and reduce carbon emissions. An investment tax credit for CHP assets is expected to encourage increased energy efficiency by accelerating planned investments and inducing additional investments in such systems. The increased demand for CHP equipment should, in turn, reduce CHP production costs and spur additional technological innovation in improved CHP systems.

### **Proposal**

The proposal would establish an 8-percent investment credit for qualified CHP systems with an electrical capacity in excess of 50 kilowatts or with a capacity to produce mechanical power in excess of 67 horsepower (or an equivalent combination of electrical and mechanical energy capacities). CHP property would be defined as property comprising a system that uses the same energy source for the simultaneous or sequential generation of (1) electricity or mechanical shaft power (or both) and (2) steam or other forms of useful thermal energy (including heating and cooling applications). A qualified CHP system would be required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof) and would also be required to satisfy an energy-efficiency standard. For CHP systems with an electrical capacity in excess of 50 megawatts (or a mechanical energy capacity in excess of 67,000 horsepower), the total energy efficiency of the system would have to exceed 70 percent. For smaller systems, the total energy

efficiency would have to exceed 60 percent. For this purpose, total energy efficiency would be calculated as the sum of the useful electrical, thermal, and mechanical power produced by the system at normal operating rates, measured on a Btu basis, divided by the lower heating value of the primary fuel source for the system supplied. The credit would be allowed with respect to qualified CHP property only if its eligibility is verified under regulations prescribed by the Secretary of the Treasury. The regulations would require taxpayers claiming the credit to obtain proper certification by qualified engineers that the system meets the energy-efficiency and percentage-of-energy tests.

Investments in qualified CHP assets that are otherwise assigned cost recovery periods of less than 15 years would be eligible for the credit, provided that the taxpayer elected to treat such property as having a 22-year class life. Thus, regular tax depreciation allowances would be calculated using a 15-year recovery period and the 150 percent declining balance method.

The credit would be treated as energy property under the investment credit component of the section 38 general business credit, and would be subject to the rules and limitations governing such property. Thus, only property placed in service in the United States would be eligible for the credit, and the basis of qualified property would be reduced by the amount of the credit. Regulated public utilities claiming the credit would be required to use a normalization method of accounting with respect to the credit. Taxpayers using the credit for CHP equipment would not be entitled to any other tax credit for the same equipment.

The credit would apply to investments in CHP equipment placed in service after December 31, 1999, but before January 1, 2003.

## **PROVIDE TAX CREDIT FOR ROOFTOP SOLAR EQUIPMENT**

### **Current Law**

A 10-percent investment tax credit is provided to businesses for qualifying equipment that uses solar energy to generate electricity, to heat or cool or to provide hot water for use in a structure, or to provide solar process heat.

### **Reasons for Change**

A tax credit for rooftop solar photovoltaic systems and solar water heating systems will reduce the cost of these investments and encourage individuals and businesses to adopt these systems. Heat and electricity from these sources produce no greenhouse gasses.

### **Proposal**

Under this proposal, a tax credit would be available for purchasers of rooftop photovoltaic systems and solar water heating systems that are located on or adjacent to a building and are used exclusively for purposes other than heating swimming pools. The credit would be equal to 15 percent of qualified investment up to a maximum of \$1,000 for solar water heating systems and \$2,000 for rooftop photovoltaic systems. This credit would be nonrefundable. For businesses, this credit would be subject to the limitations of the general business credit. The depreciable basis of the qualified property would be reduced by the amount of the credit claimed. The credit would apply only to equipment placed in service in the five-year period after December 31, 1999 and before January 1, 2005 for solar water heating systems and for the seven-year period after December 31, 1999 and before January 1, 2007 for rooftop photovoltaic systems. Taxpayers would have to choose between the proposed credit and the present tax credit for each investment.

## **EXTEND WIND AND BIOMASS TAX CREDIT AND EXPAND ELIGIBLE BIOMASS SOURCES**

### **Current Law**

Current law provides taxpayers a 1.5-cent-per-kilowatt-hour tax credit for electricity produced from wind or “closed-loop” biomass (organic material from a plant which is planted exclusively for purposes of being used at a qualified facility to produce electricity). The electricity must be sold to an unrelated third party and the credit is limited to the first 10 years of production. The credit applies only to facilities placed in service before July 1, 1999. The credit amount is indexed for inflation after 1992.

### **Reasons for Change**

The tax credit helps make electricity produced from wind and biomass competitive with other forms of electricity. Expanding eligible biomass sources will increase the use of this renewable energy source. Electricity from these sources produces no greenhouse gases.

### **Proposal**

The proposal would extend the current credit for five years, to facilities placed in service before July 1, 2004, and would expand eligible biomass sources for facilities placed in service before July 1, 2004. In addition, biomass that is co-fired in coal plants to produce electricity would be eligible for the credit at a reduced rate (1.0 cent per kilowatt hour adjusted for inflation after 1999) through June 30, 2004. Biomass qualifying for the credit would include (in addition to closed-loop biomass) any solid, nonhazardous, cellulosic waste material, that is segregated from other waste materials, and that is derived from the following forest-related resources: mill residues, pre-commercial thinnings, slash and brush, but not including old growth timber, waste pallets, crates, and dunnage, and landscape or right-of-way tree trimmings, and biomass derived from agriculture sources, including orchard tree crops, vineyard grain, legumes, sugar, and other crop-by-products or residues. Unsegregated municipal solid waste (garbage) would not qualify for the credit.



## **Promote Expanded Retirement Savings, Security, and Portability**

### **PROMOTE INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS THROUGH PAYROLL DEDUCTIONS**

#### **Current Law**

Individuals who contribute to an individual retirement account or annuity (“IRA”) typically do so by depositing funds into IRAs. However, an employee whose employer permits such an arrangement may contribute to an IRA by electing to have the employer withhold requested amounts from the employee’s paycheck and forward them to the employee’s IRA. These payroll deduction contributions to an IRA appear as wages on the employee’s Form W-2, but the employee is allowed to deduct the contributions on the employee’s tax return, subject to the normal rules governing IRA contributions.

#### **Reasons for Change**

Payroll deduction contributions to IRAs could be an important means of increasing retirement savings among employees. The advantages of saving through payroll deduction -- the convenience of contributions continuing after the employee’s initial election, reinforcement of the value of savings by peer groups in the workplace, and the incentive of tax-favored treatment of contributions -- encourage employees to save more for retirement. One way to encourage employers to offer, and employees to make, payroll deduction contributions to IRAs would be to provide employees with a convenient way to receive an immediate tax benefit for these contributions that eliminates the need for most employees to report the contributions on their tax returns and enables some employees to use simpler tax forms.

#### **Proposal**

Contributions of up to \$2,000 made to an IRA through payroll deduction generally would be excluded from an employee’s income and, accordingly, would not be reported as income on the employee’s Form W-2. However, the amounts would be subject to FICA and FUTA taxes and would be reported as a contribution to an IRA on the employee’s Form W-2. In the event the amounts would not have been deductible had the employee contributed directly to an IRA, the employee would be required to include the amounts in income on the employee’s tax return.

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

**PROVIDE SMALL BUSINESS TAX CREDIT  
FOR EXPENSES OF STARTING NEW RETIREMENT PLANS**

**Current Law**

An employer's costs related to the establishment of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees, etc.) generally are deductible as business expenses.

**Reasons for Change**

Plan start-up, plan administration, and retirement education costs may pose a barrier to the establishment of new retirement plans, especially for smaller employers. Providing a tax credit for creating new plans could promote their adoption, not only by defraying some of these costs, but also by providing a marketing tool for financial institutions or advisors to use in promoting new plan adoption and by increasing awareness of retirement saving options.

**Proposal**

The proposal would provide a three-year tax credit, in lieu of a deduction, for 50 percent of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE, SEP, or payroll deduction IRA arrangement. The credit would cover 50 percent of the first \$2,000 in administrative and retirement-education expenses for the plan or arrangement for the first year of the plan or arrangement and 50 percent of the first \$1,000 of administrative and retirement-education expenses for each of the second and third years.

The credit would be available to employers that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000, but only if the employer did not have a plan or payroll deduction IRA arrangement during any part of 1997. In order for an employer to get the credit, the plan would have to cover at least two individuals. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement would have to be made available to all employees of the employer who have worked with the employer for at least three months.

The credit would be effective beginning in the year of enactment and would be available only for plans established after 1997 and on or before December 31, 2001. For example, if an eligible employer adopted a plan in the year 2001, the credit would be available for the years 2001, 2002 and 2003.

## **THE SMART PLAN -- A SIMPLIFIED PENSION PLAN FOR SMALL BUSINESS**

### **Current Law**

Under current law, small business employers that wish to sponsor a tax-favored retirement savings plan, yet seek to avoid the administrative cost and complexity associated with traditional qualified retirement plans, may instead establish a SIMPLE plan. SIMPLE IRA and SIMPLE 401(k) plans are defined contribution plans that are not subject to many of the rules applicable to qualified retirement plans, and are subject to only minimal reporting and disclosure requirements. SIMPLE plans allow employees to make salary reduction contributions up to a lower limit (\$6,000 a year) than 401(k) plans. SIMPLE plans must provide for certain specified employer contributions.

Alternatively, small business employers may offer their employees a simplified employee pension (SEP). SEPs are employer-sponsored plans under which employer contributions are made to IRAs established by employees. Contributions under a SEP generally must bear a uniform relationship to the compensation of each employee covered under the SEP (e.g., each employee receives a contribution to the employee's IRA equal to 5 percent of the employee's compensation for the year).

### **Reasons for Change**

There is no alternative, similar to SIMPLE plans or SEPs, that is available for small business employers seeking to provide their employees with a simplified, tax-favored defined benefit pension plan. The need for complex actuarial calculations, administrative costs, and the unpredictability of funding requirements may inhibit these employers from adopting such plans.

### **Proposal**

The proposal would allow small employers to adopt a new simplified, tax-favored pension plan that combines attractive features of both defined benefit and defined contribution plans. The new plan would be known as the SMART (Secure Money Annuity or Retirement Trust) Plan. As in the case of other qualified plans, contributions to the SMART Plan would be excludable from income, earnings would accumulate tax-free, and distributions would be subject to income tax (unless rolled over).

SMART Plans would provide participants with a minimum guaranteed benefit at retirement that provides payments over the course of an employee's retirement years, and Pension Benefit Guaranty Corporation insurance, together with the potential for additional investment return and the portability of individual accounts.

## Employer Eligibility

An employer generally would be eligible to maintain a SMART Plan if the employer did not employ more than 100 employees who received at least \$5,000 in compensation in the prior year and the employer has not maintained a defined benefit pension plan or a money purchase pension plan within the preceding five years.

## Employee Eligibility and Vesting

If an employer establishes a SMART Plan, all employees who have completed two years of service with at least \$5,000 in compensation and who are reasonably expected to receive \$5,000 in compensation in the current year would participate in the Plan. An employee's benefit would be 100 percent vested at all times.

## Benefits and Funding

### *Minimum Defined Benefit*

SMART Plans would provide a fully funded minimum defined benefit, with a possible higher benefit if cumulative investment returns exceed 5 percent.

Each year the employee participates, the employee would earn a minimum annual benefit at retirement equal to 1 percent or 2 percent of compensation for that year. For example, if an employee participated for 25 years in a SMART Plan of an employer that elected a 2 percent benefit, and the employee's average salary over the entire period was \$50,000, the employee would accrue a minimum benefit of \$25,000 per year at age 65. Moreover, an employer could elect, for each of the first 5 years the SMART Plan is in existence, to provide all employees with a benefit equal to 3 percent of compensation (in lieu of 1 percent or 2 percent of compensation). The maximum compensation that could be taken into account in determining an employee's benefit for a year would be \$100,000 (indexed for inflation).

### *Funding and Investment Returns*

Funding would be provided either through a SMART Plan individual retirement annuity ("SMART Annuity") issued by an insurance company, or through a trust ("SMART Trust") that invests only in readily tradable securities and insurance products regulated by State law. Each year, an employer would be required to contribute an amount sufficient to provide the annual benefit accrued for that year payable at age 65, using actuarial assumptions specified in the statute (including a 5 percent annual interest rate).

In the case of a SMART Trust, each employee would have an account to which actual investment returns would be credited. If a participant's account balance were less than the total of past employer contributions credited with 5 percent interest per year, the employer would be required

to contribute an additional amount for the year to make up for any shortfall. Moreover, the employer would be required to contribute an additional amount for the year to make up for any shortfall between the balance in the employee's account and the purchase price of an annuity paying the minimum guaranteed benefit when an employee retires and takes a life annuity. On the other hand, if the investment returns exceeded the 5 percent assumption, the employee would be entitled to the larger account balance. If the employee elected to receive an annuity, the larger account balance would translate to a larger annuity.

In the case of a SMART Annuity, each year an employer would be required to contribute the amount necessary to purchase an annuity that provides the benefit accrual for that year on a guaranteed basis.

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

## Distributions

### *Timing*

No distributions would be allowed from a SMART Plan prior to an employee's attainment of age 65, except in the event of death or disability, or where the account balance of a terminated employee was not more than \$5,000. However, an employer could allow a terminated employee who has not yet attained age 65 to directly transfer the individual's account balance from a SMART Trust to either a SMART Annuity or a special individual retirement account ("SMART Account") that is subject to the same distribution restrictions as the SMART Trust.

If a terminated employee's account balance did not exceed \$5,000, the SMART Plan would be allowed to make a cashout of the account balance. The employee would be allowed to transfer any such distribution tax-free to a SMART Annuity, a SMART Account, or a regular IRA.

### *Form*

SMART Plans would be subject to the qualified joint and survivor annuity rules that apply to qualified defined benefit pension plans. Lump sum payments also could be made available. In addition, an employer could allow the transfer of a terminated employee's account balance from a SMART Trust to either a SMART Annuity or a SMART Account.

### *Taxation*

Distributions from SMART Plans would be subject to tax under current rules applicable to the taxation of annuities under section 72.

A 20 percent additional tax would be imposed for violating the pre-age 65 distribution restrictions under a SMART Annuity or SMART Account.

#### PBGC Guarantee and Premiums

The minimum guaranteed benefit under the SMART Trust would be guaranteed by the PBGC. Reduced PBGC premiums would apply to the SMART Trust. Neither the PBGC guarantee, nor PBGC premiums, would apply to the SMART Annuity or SMART Account.

#### Reporting and Disclosure

Because SMART Plans do not have complex actuarial calculations, they would be subject to simplified reporting requirements.

#### Nondiscrimination Requirements and Benefit Limitations

SMART Plans would not be subject to the nondiscrimination or top-heavy rules applicable to qualified retirement plans. SMART Plans also would not be subject to the limitations on benefits under section 415. However, if an employer maintained a SMART Plan, and then terminated it and established a qualified defined benefit plan, the SMART Plan accruals would be taken into account for purposes of the section 415 limitations applicable to the defined benefit plan.

#### Miscellaneous

*Other plans maintained by the employer.* An employer that maintained a SMART Plan could not maintain additional tax-qualified plans, other than a SIMPLE plan, or a 401(k) plan or 403(b) tax-sheltered annuity plan under which the only contributions that are permitted are elective contributions and matching contributions that are not greater than those provided for under the design-based safe harbor for 401(k) plans described in section 401(k)(12)(B)(I).

*Employee contributions.* No employee contributions would be permitted to a SMART Plan.

*IRS model.* The IRS would be directed to issue model SMART Plan provisions or a model SMART Plan document. Vendors and employers would have the option of using their own documents instead of the models.

*Coordination with IRA deduction rules.* SMART Plans would be treated as qualified plans for purposes of the IRA deduction phase-out rules. Thus, employees who participated in a SMART Plan and had modified AGI in excess of the applicable thresholds would be phased out of making deductible IRA contributions. This is the same rule that currently applies to SEPs and SIMPLE plans.

Calendar plan year. The plan year for all SMART Plans would be the calendar year, which would be used in applying SMART Plan contribution limits, eligibility, and other requirements.

These provisions would be effective for calendar years beginning after 1999.

## **PROVIDE FASTER VESTING OF EMPLOYER MATCHING CONTRIBUTIONS**

### **Current Law**

Generally, employer matching contributions on behalf of an employee under a section 401(k) plan (or other type of plan) either must be fully vested after the employee has completed five years of service, or must become vested in increments of 20 percent for each year beginning after the employee has completed three years of service, with full vesting after the employee has completed seven years of service. If a plan is a “top-heavy plan” within the meaning of section 416, employer matching contributions either must be fully vested after an employee has completed three years of service, or must become vested in increments of 20 percent for each year beginning after the employee has completed two years of service, with full vesting after the employee has completed six years of service. Employer matching contributions that are treated as elective contributions for purposes of the actual deferral percentage test under section 401(k) (“qualified matching contributions”) must be fully vested immediately.

### **Reasons for Change**

The popularity and importance of 401(k) plans has grown substantially over the years. Employers often choose to contribute to 401(k) plans by matching the salary reduction contributions made by employees. Given the mobile nature of today’s workforce, there is a significant risk that many participants will leave employment before fully vesting in employer matching contributions under 401(k) plans. One way to increase the portability of benefits for 401(k) plan participants is to require faster vesting for employer matching contributions.

### **Proposal**

Employer matching contributions under 401(k) plans (or other qualified plans) would be required either to be fully vested after an employee has completed three years of service, or to become vested in increments of 20 percent for each year beginning after the employee has completed two years of service, with full vesting after the employee has completed six years of service. Qualified matching contributions would continue to be fully vested immediately, as under current law.

These provisions would be effective for plan years beginning after December 31, 1999, with an extended effective date for plans maintained pursuant to a collective bargaining agreement.



## **COUNT FMLA LEAVE FOR RETIREMENT ELIGIBILITY AND VESTING PURPOSES**

### **Current Law**

Under the Family and Medical Leave Act (FMLA), eligible workers are entitled to up to 12 weeks of unpaid leave to care for a new child, to care for a family member who has a serious health condition, or because the worker has a serious health condition. The employer must provide continued medical coverage during the unpaid leave. Upon return from leave, the employee must be restored to the position or an equivalent position (i.e., same benefits, pay, and terms and conditions of employment).

Although the person must generally be restored to the same position, the employer is not required to count the period of unpaid leave for purposes of eligibility to participate in a qualified retirement plan or plan vesting.

### **Reason for Change**

Many workers, especially women, may need to leave the workforce to care for a seriously ill family member or to raise a child. This can cause them to lose service credit for determining plan eligibility or vesting. Counting FMLA leave for these purposes would increase the opportunity for workers taking time off under the FMLA to become eligible for or vest in retirement benefits.

### **Proposal**

Leave taken under the FMLA would be taken into account in determining retirement plan eligibility and vesting.

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

## **REQUIRE JOINT AND SEVENTY-FIVE PERCENT SURVIVOR ANNUITY OPTION FOR PENSION PLANS**

### **Current Law**

Traditional pension plans are currently required to offer to pay pension benefits in the form of a “joint and survivor annuity” option. This protects a surviving spouse of a plan participant by providing the spouse with regular annuity payments for life. Under these rules, an annuity payment is made as long as either spouse is alive. This amount is usually less than the amounts that would have been payable if the participant had elected a single life annuity<sup>12</sup>. However, if the participant dies first, the surviving spouse continues to receive benefit payments for life (although usually in an amount less than the amounts that were paid while both spouses were alive). Plans can meet the joint and survivor annuity requirement by offering only a joint and 50 percent survivor annuity. Under this option, the monthly pension payments to the surviving spouse are reduced to 50 percent of the level of monthly payments that were made while both spouses were alive.

### **Reason for Change**

Many couples may prefer an option that pays a somewhat smaller benefit to the couple while both are alive but a benefit larger than the 50 percent survivor benefit to the surviving spouse. Typically, a surviving spouse has retirement needs that exceed half the retirement needs of a couple. For example, the poverty threshold for an aged individual is almost 80 percent of the threshold for an aged couple. This option would be especially helpful to women, because they tend to live longer than men, and many aged widows have income below the poverty level.

### **Proposal**

Plans that are required to provide a joint and survivor annuity option would be required to offer an option that pays a lifetime benefit to the participant’s surviving spouse equal to at least 75 percent of the benefit the couple received while both were alive. Participants would not be required to choose this joint and 75 percent survivor annuity option. For example, a participant could still choose a joint and 50 percent survivor annuity (if offered under the plan) or single life annuity (with the spouse’s consent). However, a plan could limit choices for a joint and survivor annuity to a joint and 75 percent survivor annuity and satisfy this rule.

The proposal would be effective for plan years beginning after December 31, 1999 with an extended effective date for plans maintained pursuant to a collective bargaining agreement.

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<sup>12</sup>A single life annuity pays benefits only for the lifetime of the plan participant.

## **IMPROVE PENSION DISCLOSURE**

### **A. Spouse's Right to Know Distribution Information**

#### **Current Law**

In general, when a tax-qualified pension plan commences a distribution of retirement benefits to a participant in the plan, the benefits must be distributed as an annuity over the life of the participant. If the participant is married on the annuity starting date, the annuity must continue to pay at least one half of these monthly amounts to the surviving spouse following the participant's death (a form of benefit known as a "qualified joint and survivor annuity"). If the participant dies before the annuity starting date, the surviving spouse generally must be paid an annuity (known as a "qualified preretirement survivor annuity") that is not less than what the spouse would have been paid under the survivor portion of the qualified joint and survivor annuity. Most defined contribution plans (such as 401(k) plans) are not required to provide these annuities if certain conditions are satisfied, including the condition that, upon the participant's death, the participant's vested account balance is payable in full to the surviving spouse.

A plan may allow a participant to waive the right to receive these survivor annuities if certain conditions are satisfied. In particular, the spouse generally must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver. Further, the participant must have been provided with a written explanation of the terms and conditions of the survivor annuity, the participant's right to make, and the effect of, a waiver of the survivor annuity, the rights of the spouse to waive the survivor annuity, and the right of a participant to revoke the waiver. (Similar waiver and explanation rules apply concerning the death benefit payable to the spouse under a defined contribution plan.)

#### **Reasons for Change**

Although the survivor rules provide important rights to spouses, these rules do not require plans to furnish spouses a copy of the written explanation of survivor benefits that is required to be furnished to participants. In order to help spouses understand their rights and the implications of waiving these survivor benefits, spouses should be able to receive a copy of the explanation of survivor benefits.

#### **Proposal**

When an explanation of a plan's survivor benefits is provided to participants, a copy of the explanation would be required to be provided to the participant's spouse. If the last known mailing address of the participant and spouse is the same, then the explanation and a copy of the explanation can be provided in a single mailing addressed to the participant and the spouse.

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

## **B. Election Periods and Right to Know Employer Contribution Formula**

### **Current Law**

The actual deferral percentage (ADP) test generally applies to the elective contributions (typically made by salary reduction) of all employees eligible to participate in a 401(k) plan. The ADP test is satisfied if the average percentage of elective contributions for highly compensated employees does not exceed the average percentage of elective contributions for nonhighly compensated employees by a specified percentage. Because the ADP test looks to the actual pattern of deferrals by the highly compensated and nonhighly compensated employees, the employer has an incentive to increase participation by the nonhighly compensated employees and will take steps (such as publicizing the ease of saving through the plan and providing matching contributions) in order to encourage employees to contribute.

As an alternative to annual testing under the ADP test (and the similar ACP test that applies to matching contributions and after-tax employee contributions), the Small Business Job Protection Act of 1996 provided two alternative “design-based” 401(k) safe harbors, effective beginning in 1999. If the employees are provided a specified matching contribution (or a specified nonelective contribution), the employer can avoid all ADP and ACP testing of employee elective contributions and employer matching contributions. Unlike the similar safe-harbor designs under the SIMPLE plan and the SIMPLE 401(k) plan that require annual 60-day election periods and notification tied to those election periods, for 401(k) plans using a safe harbor, there are no specific requirements that prescribe the length and frequency of the election period or that tie the timing of the notice describing employee rights and obligations under the plan to the election period.

### **Reasons for Change**

Employers that use the safe harbor plan design have no built-in incentive to make it easy for employees to elect to make contributions and to notify employees of the employer matching contribution in connection with that election period. In order for the safe harbor plan design to be an adequate substitute for nondiscrimination tests, employees need to have reasonable opportunities to start making elective deferrals and need to receive information about the employer contribution formula in connection with these opportunities.

### **Proposal**

Employers that use either one of the safe harbor plan designs to avoid ADP and ACP testing would be required to provide notice and contribution opportunities comparable to those provided under SIMPLE plans. Thus, employees would have to be offered an opportunity to elect to make contributions (or modify a prior election) during a 60-day period before the beginning of each year and a 60-day period when they first become eligible. In addition, the current law requirement that employers provide employees with notice of their rights to make contributions and notice of the safe harbor contribution formula the employer is currently using (in order to notify employees of their

rights and obligations) would be modified to require the notice within a reasonable period of time before the 60-day periods begin rather than before the beginning of the year.

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

## **IMPROVE BENEFITS OF NONHIGHLY COMPENSATED EMPLOYEES UNDER 401(k) SAFE HARBOR PLANS**

### **Current Law**

The actual deferral percentage (ADP) test generally applies to the elective contributions (typically made by salary reduction) of all employees eligible to participate in a 401(k) plan. The test requires the calculation of each eligible employee's elective contributions as a percentage of the employee's pay. The ADP test is satisfied if the average percentage of elective contributions for highly compensated employees does not exceed the average percentage of elective contributions for nonhighly compensated employees by a specified percentage. Thus, the ADP test looks to the actual pattern of deferrals by the highly compensated and nonhighly compensated employees who are eligible to make elective contributions. Accordingly, the employer has a built-in incentive to encourage nonhighly compensated employees to contribute. The actual contribution percentage (ACP) test is almost identical to the ADP test, but generally applies to employer matching contributions and after-tax employee contributions under any qualified employer retirement plan.

As an alternative to annual testing under the ADP and ACP tests, the Small Business Job Protection Act of 1996 provided two alternative “design-based” safe harbors, effective beginning in 1999. If a plan were designed to use one of these safe harbors, the employer could avoid all ADP and ACP testing of employee elective contributions and employer matching contributions. Under the first safe harbor, the employer would have to make nonelective contributions of at least three percent of compensation for each nonhighly compensated employee eligible to participate in the plan. Alternatively, under the second safe harbor, the employer would have to make a 100 percent matching contribution on an employee’s elective contributions up to the first 3 percent of compensation and a matching contribution of at least 50 percent on the employee’s elective contributions up to the next 2 percent of compensation.

### **Reasons for Change**

Under the section 401(k) safe harbor plan design, employers need not perform nondiscrimination tests and may not have adequate incentives to encourage nonhighly compensated employees to contribute or to educate them about the value of tax-deferred savings for retirement. Providing a one percent nonelective contribution to all eligible nonhighly compensated employees, in addition to the matching contribution, would help demonstrate the value of tax-deferred compounding to those employees who initially might not make deferrals. This one percent contribution would also help ensure that more low- and moderate-wage workers begin accumulating savings for retirement and acquire the savings habit.

## **Proposal**

The proposal would modify the section 401(k) matching formula safe harbor by requiring that, in addition to the matching contribution, employers make a contribution of one percent of compensation for each eligible nonhighly compensated employee, regardless of whether the employee makes elective contributions.

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

## **SIMPLIFY DEFINITION OF HIGHLY COMPENSATED EMPLOYEE**

### **Current Law**

A qualified retirement plan must satisfy various nondiscrimination tests to ensure that it does not discriminate in favor of "highly compensated employees." In order to apply these tests, the employer must identify its "highly compensated employees." Under current law, effective for plan years beginning after December 31, 1996, an employee is treated as a highly compensated employee if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) for the preceding year, had compensation in excess of \$80,000 (indexed for inflation), and, if the employer elects, was in the top-paid group of employees for the preceding year. For this purpose, an employee is in the top-paid group if the employee was among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to the employees during the preceding year.

### **Reasons for Change**

The definition of highly compensated employee, while simpler than the seven-part test that applied under prior law, could be further simplified by elimination of the top-paid group election. Permitting elections that may vary from year to year increases complexity. In addition, under the current definition, it is possible for employees earning very high compensation (of several hundred thousand dollars or more) to be treated as nonhighly compensated for testing purposes if the employer has a sufficient percentage of high-paid employees in its workforce. This would allow some employers to effectively eliminate benefits for low- and moderate-wage workers without violating the nondiscrimination rules. The simplified definition of highly compensated employee should better reflect the purpose of promoting meaningful benefits for low- and moderate-wage workers, not only the high-paid.

### **Proposal**

The top-paid group election would be eliminated from the definition of highly compensated employee. Under the simplified definition, an employee would be treated as a highly compensated employee if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) for the preceding year, had compensation in excess of \$80,000 (indexed for inflation).

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



## **SIMPLIFY BENEFIT LIMITS FOR MULTIEMPLOYER PLANS UNDER SECTION 415**

### **Current Law**

Annual benefits payable under a defined benefit plan are limited to the lesser of \$130,000 (for 1999) or 100 percent of “three-year-high average compensation.” (Reductions in the dollar or percentage limit for defined benefit plans may be required if the employee has fewer than ten years of plan participation or service.) If benefits under a defined benefit plan begin before the social security retirement age, the dollar limit must be actuarially reduced to compensate for the earlier commencement. Certain special rules apply to governmental plans.

### **Reasons for Change**

The qualified plan limitations present significant administrative problems for many multiemployer plans. These plans typically base benefits on years of credited service, not on a participant's compensation. In addition, the 100 percent-of-compensation limit is based on an employee's average compensation for the three highest consecutive years. This rule often produces an artificially low limit for employees in certain industries, such as building and construction, where wages vary significantly from year to year.

### **Proposal**

The section 415 limits applicable to multiemployer plans would be modified to eliminate the 100 percent-of-compensation limit (but not the \$130,000 limit) for such plans, and to exempt certain survivor and disability benefits from the adjustments for early commencement and for participation and service of less than 10 years. This would be comparable to the changes made to the section 415 limits for governmental plans in the Small Business Job Protection Act of 1996.

The proposals would be effective for limitation years beginning after December 31, 1999.

## **SIMPLIFY FULL FUNDING LIMITATION FOR MULTIEMPLOYER PLANS**

### **Current Law**

An employer's annual deduction for contributions to a defined benefit plan may not exceed the plan's full funding limitation. The full funding limitation is generally defined as the excess of the plan's accrued liability (or, if less, a specified percentage of the plan's current liability) over the value of the plan's assets. The specified percentage is 150 percent for plan years beginning before January 1, 1999 and it increases by 5 percent every other year beginning in 1999, until it reaches 170 percent for plan years beginning on or after January 1, 2005. Whenever the specified percentage of current liability is less than the plan's accrued liability, the full funding limitation restricts the extent to which an employer can deduct contributions for benefits that have not yet accrued.

Defined benefit plans are required to have an actuarial valuation no less frequently than annually.

### **Reasons for Change**

An employer has little, if any, incentive to make "excess" contributions to a multiemployer plan, yet, under current law, the employer must perform the calculations to apply this limit. The amount an employer contributes to a multiemployer plan is determined by the collective bargaining agreement, and a particular employer's contributions are not set aside to pay benefits solely to the employees of that employer.

### **Proposal**

The limit on deductible contributions based on a specified percentage of current liability would be eliminated for multiemployer plans. Therefore, the annual deduction for contributions to such a plan would be limited to the amount by which the plan's accrued liability exceeds the value of the plan's assets. In addition, actuarial valuations would be required under the Code no less frequently than every three years for multiemployer plans. Parallel changes would be made to the Employee Retirement Income Security Act of 1974, as amended.

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

## **ELIMINATE PARTIAL TERMINATION RULES FOR MULTIEMPLOYER PLANS**

### **Current Law**

When a qualified retirement plan is terminated, all plan participants are required to become 100 percent vested in their accrued benefits to the extent those benefits are funded. In the case of certain "partial terminations" that are not actual plan terminations (e.g., a large reduction in the work force), all affected employees must become 100 percent vested in their benefits accrued to the date of the termination, to the extent the benefits are funded.

Whether a partial termination has occurred in a particular situation is generally based on specific facts and circumstances, including the exclusion from the plan of a group of employees who have previously been covered by the plan by reason of a plan amendment or severance by the employer. In addition, if a defined benefit plan stops or reduces future benefit accruals under the plan, a partial termination is deemed to occur under certain circumstances.

### **Reasons for Change**

Over the years, court decisions have left unanswered many key questions as to how to apply the partial termination rules. Accordingly, applying the rules can often be difficult and uncertain, especially for multiemployer plans. For example, multiemployer plans experience frequent fluctuations in participation levels caused by the commencement and completion of projects that involve significant numbers of union members. Many of these terminated participants are soon rehired for another project that resumes their active coverage under the plan. In addition, it is common for participants leaving one multiemployer plan's coverage to maintain service credit under a reciprocal agreement if they move to the coverage of another plan sponsored by the same union. As a result, these participants do not suffer the interruption of their progress along the plan's vesting schedule that ordinarily occurs when an employee stops being covered by a plan. Given these factors, the difficulties associated with applying the partial termination rules to multiemployer plans outweigh the benefits.

### **Proposal**

The requirement that affected participants become 100 percent vested in their accrued benefits (to the extent funded) upon the partial termination of a qualified employer retirement plan would be repealed with respect to multiemployer plans.

The proposal would be effective for partial terminations that begin after December 31, 1999.

## **ALLOW ROLLOVERS BETWEEN QUALIFIED RETIREMENT PLANS AND SECTION 403(B) TAX-SHELTERED ANNUITIES**

### **Current Law**

An eligible rollover distribution from a qualified retirement plan (i.e., a plan qualified under section 401(a) or 403(a)) may be either (1) rolled over by the distributee to an eligible retirement plan if the rollover occurs within 60 days of the distribution, or (2) directly rolled over by the distributing plan to an eligible retirement plan. Generally, an "eligible rollover distribution" is a distribution other than (1) a distribution which is required under section 401(a)(9) or (2) a distribution which is part of a series of substantially equal periodic payments made for life, life expectancy or over a period of ten years or more. An "eligible retirement plan" is a section 401 plan, a section 403(a) plan or an IRA. In the case of section 403(b) tax-sheltered annuities, distributions which would be eligible rollover distributions except for the fact that they are distributed from a section 403(b) tax-sheltered annuity may be rolled over to another section 403(b) tax-sheltered annuity or a traditional IRA. Under these rules, for example, an eligible rollover distribution from a section 401(k) plan may not be rolled over to a section 403(b) tax-sheltered annuity, and an eligible rollover distribution from a section 403(b) tax-sheltered annuity may not be rolled over to a section 401(k) plan.

An amount may be rolled over from a qualified retirement plan to a traditional IRA and subsequently rolled over to another qualified retirement plan if amounts in the IRA are attributable only to rollovers from qualified retirement plans. Also, under these "conduit IRA" rules, an amount may be rolled over from a section 403(b) tax-sheltered annuity to a traditional IRA and subsequently rolled over to a section 403(b) tax-sheltered annuity if amounts in the IRA are attributable only to rollovers from section 403(b) tax-sheltered annuities.

### **Reasons for Change**

Given the increasing mobility of the American workforce, some individuals could accumulate a number of small retirement savings accounts and small amounts in many different qualified retirement plans and section 403(b) tax-sheltered annuities. Expansion of the current law rules permitting rollovers between qualified retirement plans and section 403(b) tax-sheltered annuities would allow participants in these plans to combine their retirement plan savings in one vehicle if they change jobs.

### **Proposal**

An eligible rollover distribution from a qualified retirement plan could be rolled over to a qualified retirement plan, a section 403(b) tax-sheltered annuity, or a traditional IRA. Likewise, an eligible rollover distribution from a section 403(b) tax-sheltered annuity could be rolled over to another section 403(b) tax-sheltered annuity, a qualified retirement plan, or a traditional IRA. The conduit IRA rules would be modified in the same manner. A special rule would prevent participants

from receiving special capital gains and income averaging treatment available to distributions from qualified retirement plans if their accounts include any amounts previously held under a section 403(b) tax-sheltered annuity.

The proposal would be effective for distributions after December 31, 1999.

## **ALLOW ROLLOVERS FROM REGULAR IRAS TO QUALIFIED RETIREMENT PLANS OR SECTION 403(B) TAX-SHELTERED ANNUITIES**

### **Current Law**

Regular contributions to a traditional IRA (i.e., contributions subject to the deduction limitations of section 219, as opposed to rollover contributions from a qualified retirement plan or a section 403(b) tax-sheltered annuity) cannot be directly or indirectly rolled over to a qualified retirement plan or a section 403(b) tax-sheltered annuity.

### **Reasons for Change**

Expansion of the current law rules permitting rollovers will allow participants in qualified retirement plans or section 403(b) tax-sheltered annuities, who also have made regular contributions to traditional IRAs, more opportunities to consolidate their retirement savings in one vehicle.

### **Proposal**

Under this proposal, individuals who have a traditional IRA and whose IRA contributions have all been tax deductible would be offered the opportunity to transfer funds from their traditional IRA into their qualified defined contribution retirement plan or section 403(b) tax-sheltered annuity -- provided that the retirement plan trustee meets the same standards as an IRA trustee.

The proposal would be effective for distributions after December 31, 1999.

## **ALLOW ROLLOVERS OF AFTER-TAX CONTRIBUTIONS**

### **Current Law**

Employees are allowed to make after-tax contributions to qualified retirement plans. However, they are not permitted to roll over distributions of those after-tax contributions to a traditional IRA or another qualified retirement plan.

### **Reasons for Change**

After-tax savings in qualified retirement plans enhance retirement security. Allowing such distributions to be rolled over to a traditional IRA or another qualified retirement plan would increase the chances that those amounts would be retained until needed for retirement.

### **Proposal**

After-tax employee contributions to a qualified retirement plan could be included in a rollover contribution to a traditional IRA or another qualified retirement plan, provided that the plan or IRA provider agrees to track and report the after-tax portion of the rollover for the individual. Distributions of after-tax contributions would continue to be nontaxable.

The proposal would be effective for distributions after December 31, 1999.

**ALLOW ROLLOVERS OF CONTRIBUTIONS FROM NONQUALIFIED  
DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS  
TO IRAS**

**Current Law**

Unlike participants in qualified retirement plans and section 403(b) tax-sheltered annuities, participants in eligible nonqualified deferred compensation plans of State and local governments under section 457(b) (also known as “governmental section 457 plans”) may not roll over distributions from these plans to IRAs. Accordingly, amounts distributed from these plans are includable in gross income on distribution.

**Reasons for Change**

Like participants in qualified retirement plans and section 403(b) tax-sheltered annuities, participants in governmental section 457 plans should be able to transfer distributed amounts to IRAs, thereby further deferring tax on retirement savings.

**Proposal**

The proposal would allow individuals to roll over distributions from a governmental section 457 plan to a traditional IRA.

The proposal would be effective for distributions after December 31, 1999.



## **FACILITATE THE PURCHASE OF SERVICE CREDITS IN GOVERNMENTAL DEFINED BENEFIT PLANS**

### **Current Law**

Employees of State and local governments, particularly teachers, often move between States and school districts in the course of their careers. Under State law, these employees often have the option of purchasing service credits in their State defined benefit pension plans in order to make up for time spent in another State or district. With purchase of these service credits, workers can earn a pension reflecting a full career of employment in the State in which they conclude their career. Under current law, these employees cannot make a tax-free transfer of the money they have saved in their section 403(b) tax-sheltered annuities or governmental section 457 plans to purchase these service credits.

### **Reason for Change**

The inability to make tax-free transfers from section 403(b) tax-sheltered annuities and governmental section 457 plans to purchase permissive service credits poses a barrier to portability for employees of State and local governments, particularly for those employees who lack other resources to use for this purpose.

### **Proposal**

Under the proposal, State and local government employees would be able to use funds from their section 403(b) tax-sheltered annuities or governmental section 457 plans to purchase service credits through a direct transfer without first having to take a taxable distribution of these amounts.

The proposal would be effective for transfers made after December 31, 1999.

## **Extend Expiring Provisions**

### **EXTEND AMT RELIEF FOR INDIVIDUALS**

#### **Current Law**

An individual is subject to an alternative minimum tax (AMT) to the extent the individual's tentative minimum tax is greater than his or her regular tax liability. In addition, an individual generally is allowed to offset his or her tax liability with the nonrefundable personal credits (e.g., the child and dependent care credit, adoption credit, child credit, and the Hope and Lifetime Learning credits) only to the extent the individual's regular tax (determined before such credits) exceeds his or her tentative minimum tax. A special rule, applicable only to the 1998 tax year, allows an individual to offset his or her regular tax liability by nonrefundable tax credits regardless of the amount of the individual's tentative minimum tax.

#### **Reasons for Change**

The original individual AMT was enacted in the 1960's as a separate tax system within the income tax because of a belief that many upper-income individuals were avoiding regular tax through the use of certain tax preferences. Over time, the individual AMT has become less focused, as some of these tax preferences have been removed from the regular tax base, while others have been deleted from the AMT base.

The Administration is concerned that the individual AMT may impose financial and compliance burdens upon taxpayers that have few tax preference items and were not the originally intended targets of the AMT. In particular, the Administration is concerned that the individual AMT may act to erode the benefits of nonrefundable tax credits that are intended to provide tax relief for middle income taxpayers. In response, the Administration proposes to extend, as a temporary relief measure, the provision enacted in 1998 that facilitates the use of personal credits. The Administration looks forward to working with Congress to address the long-term issues raised by the individual AMT.

#### **Proposal**

The proposal would allow an individual, for taxable years 1999 and 2000, to offset his or her regular tax liability by nonrefundable tax credits regardless of the amount of the individual's tentative minimum tax.

## **EXTEND THE WORK OPPORTUNITY TAX CREDIT**

### **Current Law**

A work opportunity tax credit (WOTC) currently is provided for hiring individuals from certain targeted groups. The credit equals a percentage of qualified wages paid during the first year of the individual's employment with the employer. 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 or more hours. The maximum amount of qualified wages paid to an individual is \$6,000. The credit expires with respect to employees who begin work after June 30, 1999.

### **Reasons for Change**

The goal of the Work Opportunity Tax Credit is to provide employers with a tax incentive to hire individuals who have traditionally had difficulty entering and remaining in the work force. An extended wage credit would continue to serve as an inducement for employers to hire these individuals and to invest in their training.

### **Proposal**

The Work Opportunity Tax Credit would be extended so that the credit would apply with respect to employees who begin work before July 1, 2000.

The proposal would also clarify the coordination of the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit with respect to an individual whose first year of employment does not coincide with the employer's taxable year. The proposed clarification would be effective for taxable years beginning on or after the date of first committee action.

## **EXTEND THE WELFARE-TO-WORK TAX CREDIT**

### **Current Law**

The welfare-to-work tax credit enables employers to claim a tax credit for eligible wages paid to certain long-term family assistance recipients. 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. Thus, the maximum credit is \$8,500 per qualified employee. The credit expires with respect to individuals who begin work after June 30, 1999.

### **Reasons for Change**

Extending the welfare-to-work tax credit would continue to encourage employers to hire, invest in training, and provide certain benefits and more permanent employment, to long-term welfare recipients.

### **Proposal**

The welfare-to-work tax credit would be extended for one year, so that the credit would be effective for individuals who begin work before July 1, 2000.

## **EXTEND THE R&E TAX CREDIT**

### **Current Law**

The research tax credit generally applies on an incremental basis to a taxpayer's "qualified research" expenses for a taxable year. The credit generally is equal to 20 percent of the amount by which the taxpayer's qualified research expenses for the taxable year exceed a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years. The base amount cannot be less than 50 percent of the taxpayer's qualified research expenses for the taxable year.

Taxpayers are allowed to elect an alternative incremental credit for any taxable year beginning after June 30, 1996. 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 current law) and the credit rate likewise is reduced.

The research credit is not available for activities conducted outside the United States. Puerto Rico is not a part of the United States for purposes of this provision.

The credit expires for qualified research expenses paid or incurred after June 30, 1999.

### **Reasons for Change**

The Administration supports the extension of the research tax credit. The Administration recognizes the importance of technology to our national ability to compete in the global marketplace, and the research credit is useful in supporting and fostering technology. The credit provides incentives for private-sector investment in research and innovation that can help increase America's economic competitiveness and enhance U.S. productivity. The Administration also believes that the credit should be extended to research activities by U.S. corporations in Puerto Rico.

### **Proposal**

The research tax credit would be extended for twelve months, from July 1, 1999 to June 30, 2000. Under the proposal, the credit would be available with respect to qualified activities conducted in Puerto Rico for taxable years beginning on or after the date of enactment.

## **MAKE PERMANENT THE EXPENSING OF BROWNFIELDS REMEDIATION COSTS**

### **Current Law**

Generally, costs incurred to clean up land and groundwater increase the value of any property and are not currently deductible, but must be capitalized. In a ruling issued in 1994 (Revenue Ruling 94-38), the IRS concluded that certain environmental cleanup costs incurred are currently deductible as business expenses. That ruling only addressed cleanup costs incurred by the same taxpayer that contaminated the land, rather than someone who acquired previously contaminated property.

As part of the Taxpayer Relief Act of 1997, certain remediation costs are currently deductible if incurred with respect to a qualified contaminated site, "so-called brownfields". Generally, these expenses are limited to those paid or incurred in connection with the abatement or control of environmental contaminants. For example, expenses incurred with respect to the demolition of existing buildings and their structural components do not qualify for this treatment except in the unusual circumstance where the demolition is required as part of ongoing remediation. This deduction applies for both alternative minimum tax and regular tax purposes.

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. Targeted areas are defined as: (1) empowerment zones and enterprise communities; (2) sites that were announced before February 1997 as being subject to one of the 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.

This special treatment does not apply to expenditures paid or incurred after December 31, 2000.

### **Reasons for Change**

The Administration believes that encouraging environmental remediation is an important national goal. Extending special treatment on a permanent basis would remove doubt among taxpayers as to the future deductibility of remediation expenditures and would promote the goal of encouraging environmental remediation.

### **Proposal**

The proposal would make permanent the deduction under section 198 for brownfields remediation costs. The restriction requiring that expenditures must be paid or incurred on or before December 31, 2000 in order to be deductible as environmental remediation expenditures would be eliminated.

## **EXTEND TAX CREDIT FOR FIRST-TIME D.C. HOMEBUYERS**

### **Current Law**

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers).

The credit expires for residences purchased after December 31, 2000.

### **Reasons for Change**

The Administration recognizes the importance of a stable residential base for the District of Columbia and the need to attract new homeowners to the District of Columbia.

### **Proposal**

The D.C. first-time homebuyer tax credit would be extended for twelve months, from January 1, 2001 to December 31, 2001.

## **Simplify the Tax Laws**

### **PROVIDE OPTIONAL SELF-EMPLOYMENT CONTRIBUTIONS ACT (SECA) COMPUTATIONS**

#### **Current Law**

The Self-Employment Contributions Act (SECA) imposes taxes on net earnings from self-employment to provide social security coverage to self-employed workers. The maximum amount of earnings subject to the self-employment (or SECA) tax is coordinated with, and is set at the same level as, the maximum level of wages and salaries subject to FICA taxes (\$72,600 for OASDI taxes in 1999 and indexed annually, and without limit for the Hospital Insurance tax).

Special rules allow certain self-employed individuals to continue to maintain social security coverage during a period of low income. The method applicable to farmers is slightly more favorable than the method applicable to other self-employed persons. A farmer may increase his or her self-employment income, for purposes of obtaining social security coverage, by reporting two thirds of the first \$2,400 of gross income as net earnings from self-employment, i.e., the optional amount of net earnings from self-employment would not exceed \$1,600. There is no limit to the number of times a farmer may use this method. The optional method for non-farm income is similar, also permitting two thirds of the first \$2,400 of gross income to be treated as self-employment income. However, the optional non-farm method may not be used more than five times by any individual, and may only be used if the taxpayer had net earnings from self-employment of \$400 or more in at least two of the three years immediately preceding the year in which the optional method is elected.

#### **Reasons for Change**

Combining the two different optional methods of computing self-employment income for self-employment tax purposes into a single combined optional method will simplify the self-employment tax for the approximately 45,000 taxpayers (in 1994) who use one of these methods. Forms and instructions will also be simplified for the millions of self-employed workers who do not use the optional methods.

There is no policy reason for providing different methods for farm and non-farm self-employed workers. By permitting non-farm self-employed workers to use the more liberal requirements that currently apply to the farm optional method, more non-farm self-employed persons would be expected to use the combined optional method and, thereby, to obtain additional social security and Medicare coverage and, eventually, to receive higher social security benefits.



## **Proposal**

The two current optional methods would be combined into a single combined optional method under which self-employment income for SECA tax purposes would be two-thirds of the first \$2,400 of gross income. A self-employed worker could elect the proposed combined optional method an unlimited number of times. If it is used, it would have to be applied to all self-employment earnings for the year, both farm and non-farm.

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

## **PROVIDE STATUTORY HEDGING AND OTHER RULES TO ENSURE BUSINESS PROPERTY IS TREATED AS ORDINARY PROPERTY**

### **Current law**

Under current law, there is a significant issue of whether income from hedging transactions is capital or ordinary. The Supreme Court in Arkansas Best Corp. v. Commissioner, 350 U.S. 46 (1955), established a restrictive definition of ordinary asset. As a result, the IRS sought to treat certain business hedges as capital assets. That effort resulted in additional litigation and considerable taxpayer efforts to change the rules legislatively.

In 1994, the IRS and Department of the Treasury finalized regulations to provide ordinary character for most business hedges and to provide rules to ensure that the timing of income or loss from hedging transactions matches the timing of economically offsetting income or loss from the related hedged items.

### **Reasons for Change**

The hedging regulations issued by the Department of the Treasury do not eliminate the possibility that a business hedge can be improperly characterized for tax purposes. The rules governing hedging transactions need to be modernized.

### **Proposal**

The proposal would codify the approach taken in the regulations and make some modifications to clarify the rules. In particular, the proposal would add three categories of ordinary assets to section 1221: (1) "dealer derivatives contracts," (2) supplies of a type regularly used by the taxpayer in the provision of services or the production of ordinary property, and (3) "hedging transactions." A new provision would define "dealer derivative contract" as a derivative contract that is purchased or written by a taxpayer that makes a market in derivatives contracts in the course of the taxpayer's trade or business. A new provision would define "hedging transactions" as transactions entered into primarily to manage the risk of ordinary property held or to be held, or certain liabilities incurred or to be incurred. Importantly, a transaction would qualify as a hedging transaction only if it were identified as a hedging transaction on the books and records of the taxpayer. If a transaction was improperly identified as a hedging transaction, losses would retain their usual character (i.e., usually capital), but gains would be ordinary. If a hedging transaction was not identified, gains would be ordinary but losses would retain their non-hedging character. Other rationales for ordinary treatment (such as surrogacy for a non-capital asset or insurance against a business risk) would not be allowed.

The proposal would provide that the timing of income, gain, deduction, or loss from a hedging transaction must reasonably match the timing of the income, gain, deduction, or loss from the hedged item.

The proposal generally would be effective after the date of enactment, and would give the Treasury Department authority to issue regulations similar to the hedging provisions governing hedging transactions entered into prior to the effective date.

## **CLARIFY RULES RELATING TO CERTAIN DISCLAIMERS**

### **Current Law**

State laws permit donees of gifts and bequests to refuse to accept (i.e., disclaim) such transfers prior to acceptance. In that event, State laws typically provide that the disclaimed property passes as if the intended recipient died before the transfer was made. Under section 2518, a State law type disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property, the disclaimer is made in writing not later than nine months after the transfer creating the interest occurs, and certain other requirements are satisfied. Disclaimers are permitted for an “undivided portion” of the disclaimant’s interest. Also, a spouse is permitted to disclaim even when the result of the disclaimer is that the disclaimed property will pass to a trust of which the spouse is a beneficiary. When a qualified disclaimer is made, the property passes in accordance with State law and the transfer tax provisions apply as if no transfer had been made to the disclaiming person. The effect of a qualified disclaimer for Federal income tax purposes is unclear.

Certain transfers of property also can be treated as qualified disclaimers under section 2518(c)(3). In order to qualify, these transfer-type disclaimers must be a written transfer of the disclaimant’s “entire interest in the property” to the person who would have received the property had there been a valid disclaimer under State law. Like other disclaimers, the transfer-type disclaimer generally must be made within nine months of the transfer creating the interest.

### **Reasons for Change**

The Administration wishes to clarify that transfer-type disclaimers should be treated the same as non-transfer-type disclaimers. In addition, qualified disclaimers should be effective for income tax purposes as well as for transfer tax purposes, so that if a person disclaims property that is income in respect of a decedent (IRD), the income tax liability for the IRD goes with the disclaimed property.

### **Proposal**

The proposal would amend the disclaimer rules to state that, in the case of a transfer-type disclaimer, partial disclaimers are permitted and a spouse can make a disclaimer that is effective for gift tax purposes even where the disclaimed property passes to a trust in which the surviving spouse has an income interest. The proposal also would clarify that disclaimers are effective for income tax purposes. This proposal would apply to disclaimers made after the date of enactment.

## **SIMPLIFY THE FOREIGN TAX CREDIT LIMITATION FOR DIVIDENDS FROM 10/50 COMPANIES**

### **Current Law**

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

Special foreign tax credit limitation rules apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is neither a controlled foreign corporation nor a passive foreign investment company (a so-called "10/50 company"). Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a *separate* foreign tax credit limitation for *each* 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, from earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a *single* foreign tax credit limitation for *all* 10/50 companies. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, from earnings and profits accumulated in taxable years beginning after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

### **Reasons for Change**

With respect to dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, the concurrent application of both the single basket approach (for pre-2003 earnings and profits) and the look-through approach (for post-2002 earnings and profits) will result in significant complexity to taxpayers. A reduction in complexity and compliance burdens will reduce the bias against U.S. participation in foreign joint ventures and foreign investment by U.S. companies through affiliates that are not majority owned.

### **Proposal**

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated. The proposal would grant regulatory authority to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of the stock, including rules to disregard preacquisition earnings and profits, and foreign taxes, in appropriate circumstances. The proposal would be effective for taxable years beginning after December 31, 1998.

## **INTEREST TREATMENT FOR DIVIDENDS PAID BY CERTAIN REGULATED INVESTMENT COMPANIES TO FOREIGN PERSONS**

### **Current Law**

Interest income and short-term capital gains received by a U.S. money market or bond mutual fund are recharacterized as dividend income that is subject to U.S. withholding tax when distributed to foreign investors. However, in general, no U.S. withholding tax is imposed on interest income and short-term capital gains received by foreign investors from direct investments or investments through foreign funds in U.S. bonds and money market instruments.

### **Reasons for Change**

Imposition of U.S. withholding tax on investments through U.S. money market or bond mutual funds, when tax is not imposed on comparable investments through foreign funds, puts U.S. mutual funds at a significant competitive disadvantage in attracting foreign investors. The proposal would eliminate this disadvantage, as well as needless complications now associated with structuring vehicles for foreign investment in U.S. debt securities.

### **Proposal**

The proposal generally would treat all income received by a U.S. mutual fund that invests substantially all of its assets in U.S. debt securities or cash as interest that is exempt from U.S. withholding tax. In determining whether a fund invests substantially all of its assets in U.S. debt securities or cash, a fund generally will not fail to meet this test if it also invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries.

The proposal would be effective for mutual fund taxable years beginning after the date of enactment.

## **EXPAND DECLARATORY JUDGMENT REMEDY FOR NONCHARITABLE ORGANIZATIONS SEEKING DETERMINATIONS OF TAX-EXEMPT STATUS**

### **Current Law**

In contrast to the rules governing charities, non-charities (i.e., organizations not described in section 501(c)(3)) generally are not required to file an application with the IRS to obtain a determination of their tax-exempt status. In practice, however, some organizations voluntarily do so by filing a Form 1024. If an organization that voluntarily files Form 1024 later receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. The IRS position could be challenged in court only in the context of a deficiency or refund proceeding.

Under current law, any organization seeking tax-exempt status as a charity under section 501(c)(3) is allowed to seek a declaratory judgment as to its tax status if its application for recognition of exemption is denied or delayed by the IRS.

### **Reasons for Change**

One reason that non-charities voluntarily file Form 1024 is to achieve greater certainty about their tax status. However, this goal is undermined if the IRS determination is delayed for a significant period of time. If such an organization ultimately receives an adverse determination from the IRS with respect to its tax-exempt status, the organization faces potential tax liability for the period during which its application was pending at the IRS.

### **Proposal**

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. Thus, if the application of any organization seeking tax-exempt status under section 501(c) is pending with the IRS for more than 270 days, and the organization has exhausted all administrative remedies available within the IRS, then the organization may seek a declaratory judgment as to its tax status from the United States Tax Court.

The proposal would be effective for applications for recognition of exemption filed after December 31, 1999.

## **SIMPLIFY THE ACTIVE TRADE OR BUSINESS REQUIREMENT FOR TAX-FREE SPIN-OFFS**

### **Current Law**

In order for a spin-off, split-off, or split-up to qualify for tax-free treatment, among other requirements, either the distributing and controlled corporations both must be engaged in the active conduct of a trade or business immediately after the distribution or, immediately before the distribution, the distributing corporation must have no assets other than stock or securities in the controlled corporations and each of the controlled corporations must be engaged in the active conduct of a trade or business immediately after the distribution. If a corporation is not itself active, it may satisfy the active trade or business test indirectly, but only if substantially all of its assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.

### **Reasons for Change**

Because the substantially all standard is much higher than that required if the corporation is directly engaged in the active conduct of a trade or business, a taxpayer often must engage in pre-distribution restructurings that it otherwise would not have undertaken. There is no clear policy reason that justifies imposing a different standard for meeting the active trade or business requirement depending upon whether a corporation is considered to be active on a direct or indirect basis.

### **Proposal**

The Administration proposes to simplify the active trade or business requirement by removing the substantially all test and generally allowing an affiliated group to satisfy this requirement as long as the relevant affiliated group, taken as a whole, is considered active. The relevant affiliated group would be determined immediately after the distribution. With respect to the distributing corporation, the relevant affiliated group would consist of the distributing corporation as the common parent and all corporations (regardless of whether such corporations are includable corporations under section 1504(b)) connected with the distributing corporation through stock ownership described in section 1504(a)(1)(B). The relevant affiliated group for the controlled corporation would be determined in the same manner, treating the controlled corporation as the common parent of such group.

This proposal would be effective for transactions after the date of enactment.

## **Miscellaneous Provisions**

### **EXTEND AND MODIFY PUERTO RICO ECONOMIC-ACTIVITY TAX CREDIT (SECTION 30A)**

#### **Current Law**

Domestic corporations with business operations that were established by October 13, 1995 in U.S. possessions may continue to benefit from the credit provided under section 936 or 30A to reduce or eliminate the U.S. tax on certain income that is related to their possession-based operations. The credit may offset the U.S. tax on income arising from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business. The credit offsets the beneficiary corporation's U.S. tax whether or not it pays income tax to the possession.

Limitations on the credit were enacted in 1993, and the credit was repealed in 1996, subject to a phase-out for companies benefitting at that time from the credit.

Currently, under the phase-out, beneficiary companies operating in Puerto Rico calculate the allowable credit either (1) taking 40 percent of the credit as allowed under prior law, subject to a cap based on pre-1996 possessions income (claimants with the percentage limitation in place for their 1997 fiscal year), or (2) based on the company's economic activity in Puerto Rico (measured by wages and other compensation, depreciation, and certain taxes paid), subject beginning in 2002 to a cap based on pre-1996 possessions income. (The credit under the economic-activity regime is provided in section 30A.)

No credit is available in taxable years beginning after December 31, 2005. No credit is available with respect to business operations established after October 13, 1995.

#### **Reasons for Change**

The Administration proposed to reformulate the credit in 1993 and again in 1996 to make it a more efficient incentive for job creation and economic activity in Puerto Rico; the amendments enacted in 1993 moved part way toward the Administration's proposals, but the phase-out enacted in 1996 eliminated all incentives for new investment in Puerto Rico. The Administration continues to believe that there should be a tax credit to provide an incentive for increased economic activity in Puerto Rico.

#### **Proposal**

To provide a more efficient and effective tax incentive for the economic development of Puerto Rico and to continue the shift from an income-based credit to an economic-activity-based credit that was begun in the 1993 Act, the proposal would modify the economic-activity-based credit under section 30A by (1) opening it to newly established business operations, effective for taxable



years beginning after December 31, 1998, and (2) extending the phase-out to cover taxable years beginning before January 1, 2009.

## **MAKE FIRST \$2,000 OF SEVERANCE PAY EXEMPT FROM INCOME TAX**

### **Current Law**

Severance payments are includable in the gross income of the recipient.

### **Reasons for Change**

The tax on severance payments places an additional burden on displaced workers, especially if the worker is separated from service because of a reduction in work force by the employer, in which case it may be difficult for the worker to find new, comparable employment.

### **Proposal**

Under the proposal, up to \$2,000 of certain severance payments would be excludable from the income of the recipient. This exclusion would apply to payments received by an individual who was separated from service in connection with a reduction in the employer's work force. The exclusion is not available if the individual attains employment within six months of the separation from service at a compensation level that is at least 95 percent of the compensation the individual received before the separation from service. The exclusion also does not apply if the total severance payments received by the individual exceed \$75,000.

The proposal would be effective for severance pay received in taxable years beginning after December 31, 1999 and before January 1, 2003.

## **EXTEND CARRYBACK PERIOD FOR NOLS OF STEEL COMPANIES**

### **Current Law**

Under current law, a net operating loss (NOL) of a taxpayer generally may be carried back 2 years and forward 20 years. Special carryback rules apply to specified liability losses (10 years), farm losses (5 years), casualty or theft losses (3 years), losses of small businesses and farmers attributable to activities in a Presidentially declared disaster area (3 years), and losses of real estate investment trusts (no carryback).

### **Reasons for Change**

Some steel companies are experiencing financial troubles. The benefit proposed by the Administration will feed directly into a financially troubled steel company's cash flow, providing immediate needed relief.

### **Proposal**

The proposal would extend the carryback period for the NOL of a steel company to 5 years. The proposal would not change the 20-year carryforward period. An eligible taxpayer could elect to forgo the 5-year carryback and apply the current-law carryback rules. Only losses related to activities incurred in the manufacture or production of steel and steel products would be eligible for the 5-year carryback.

The proposal would be effective for taxable years ending after the date of enactment, regardless of when the NOL arose. The provision would not apply to taxable years ending five years after the date of enactment.

## **Electricity Restructuring**

### **TAX-EXEMPT BONDS FOR ELECTRIC FACILITIES**

#### **Current Law**

Interest on State and local government bonds generally is excluded from gross income if the bonds are issued to finance governmental activities. Bonds issued by State and local governments are governmental bonds unless the bonds are private activity bonds. Bonds are private activity bonds if the issue meets both the private use test and private payment or security test. Bonds are also private activity bonds if the issue satisfies the private loan test.

Facilities for electric generation, transmission, and distribution are eligible for financing with governmental tax-exempt bonds when the financed facilities are used by or paid for by a State or local governmental entity. Generally, bond-financed facilities are used for a governmental purpose even when the electricity they generate or transmit is sold to private persons provided those persons are treated as members of the general public. Private use arises, however, when electricity is sold under terms, such as under take-or-pay contracts, which transfer the benefits and burdens of ownership of the facility to private persons. Such private use may render the interest on outstanding bonds taxable.

Treasury and IRS have written temporary and proposed regulations that will enable State and local government issuers of tax-exempt bonds that finance output facilities to comply with current provisions of the Internal Revenue Code relating to private activity bonds and still participate, to a limited extent, in a deregulated environment. These regulations were published in the Federal Register on January 22, 1998. They became effective on February 23, 1998. Because the regulations are temporary, they expire under law three years after they are published.

#### **Reasons for Change**

Restructuring the electric industry to deregulate transmission service and encourage retail competition promises significant economic benefits to both business and household consumers of electricity. On March 24, 1998, the Department of Energy announced the Administration's Comprehensive Electricity Competition Plan (the Plan) which is estimated to save consumers \$20 billion per year. Full implementation of the Plan requires revision of the rules governing private use of tax-exempt bond-financed electric facilities.

In order to develop efficient nondiscriminatory transmission services, publicly-owned electric utility companies will be required to turn the operation of their transmission facilities over to independent systems operators or use those facilities in a manner that may violate the private use rules. As traditional service areas of both investor-owned and publicly-owned systems are opened to retail competition, the latter may find it necessary to enter into contracts with private users of electricity in order to prevent their generation facilities from becoming stranded costs. Without relief from the

private use rules, publicly-owned electric systems may not choose to open their service areas to competition or to allow their transmission facilities to be operated by a private party.

### **Proposal**

No new facilities for electric generation or transmission may be financed with tax-exempt bonds after enactment of legislation implementing the Plan. Because electric distribution facilities are inherently local and in a restructured industry will continue to serve customers as members of the general public, distribution facilities may continue to be financed with tax-exempt bonds subject to existing private use rules. Distribution facilities are facilities operating at 69 kilovolts or less (including functionally related and subordinate property).

Bonds issued to finance transmission facilities before enactment of legislation implementing the Plan would continue their tax-exempt status if private use resulted from action pursuant to a FERC order requiring non-discriminatory open access to those facilities. Under the Plan, FERC would be given the power to require publicly-owned electric utilities to provide such open access. Bonds issued to finance generation or distribution facilities issued before enactment of legislation implementing the Plan would continue their tax-exempt status if private use results from retail competition, or if private use results from the issuer entering into a contract for the sale of electricity or use of its distribution property that will become effective after implementation of retail competition. Sale of facilities financed with tax-exempt bonds to private entities would continue to constitute a change in use. Bonds issued to refund, but not advance refund, bonds issued before enactment of legislation implementing the Plan would be permitted.

The proposal would be effective on the date of enactment.

## **MODIFY TREATMENT OF CONTRIBUTIONS TO NUCLEAR DECOMMISSIONING FUNDS**

### **Current law**

Current law allows a deduction for contributions to a qualified nuclear decommissioning fund. The amount that may be contributed for a taxable year is limited to the lesser of the cost of service amount or the ruling amount. The cost of service amount is the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. The ruling amount is the amount that the IRS determines to be necessary to provide for level funding of an amount equal to the taxpayer's nuclear decommissioning costs. The IRS specifies a schedule of these amounts in a ruling issued to the taxpayer. If circumstances change, a taxpayer may request a revised schedule of ruling amounts. In addition, the schedule is reviewed at intervals of no more than 10 years.

### **Reasons for Change**

The favorable tax treatment of contributions to nuclear decommissioning funds recognizes the national importance of the establishment of segregated reserve funds for paying nuclear decommissioning costs. Although the favorable tax treatment was adopted at a time when nuclear power plants were operated by regulated public utilities, deregulation will not reduce the need for such funds. Deregulation will, however, generally eliminate traditional cost of service determinations for ratemaking purposes. In many cases, a line charge or other fee will be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning, but there is no assurance that this will be the case under all State deregulation plans.

### **Proposal**

The cost of service requirement for deductible contributions to nuclear decommissioning funds would be repealed. Thus, taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified nuclear decommissioning fund. As under current law, however, the maximum contribution and deduction for a taxable year could not exceed the ruling amount for that year.

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

## **Corporate Tax Shelters**

### **MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR CORPORATE TAX SHELTERS**

#### **Current Law**

The substantial understatement penalty imposes a 20 percent penalty on any substantial understatement of tax. The penalty was modified in 1994 and 1997 to more effectively deter aggressive corporate tax shelters. The 1994 modification eliminated, with respect to corporate taxpayers, the exception to the substantial understatement penalty regarding tax shelter items for which the taxpayer had substantial authority and reasonably believed that its treatment was more likely than not the proper treatment. Instead, the substantial understatement penalty applied unless the taxpayer could demonstrate reasonable cause and acted in good faith with respect to the portion of the underpayment attributable to the tax shelter item (section 6664(c)). The legislative history stated that a determination by the taxpayer or a professional tax advisor that the substantial authority and more likely than not standards were satisfied would be an important factor, but not enough by itself, to establish that the reasonable cause exception applied. It was the intent of the provision that the standards applicable to corporate shelters be tightened. In 1997, the statutory definition of a tax shelter was modified to eliminate the requirement that the tax shelter have as “the principal purpose” the avoidance or evasion of Federal income tax and required that the tax shelter have only as “a significant purpose” the avoidance or evasion of tax.

#### **Reason for Change**

Despite the heightened substantial understatement penalty for corporate tax shelters, there continue to be a significant number of abusive tax shelter transactions involving corporate taxpayers. The more narrow reasonable cause exception for corporate tax shelters does not appear to adequately deter such transactions. Accordingly, the standards applicable to corporate tax shelters should be tightened.

#### **Proposal**

The proposal would increase the penalty applicable to a substantial understatement by corporate taxpayers from 20 percent to 40 percent for any item attributable to a corporate tax shelter. The penalty would be reduced to 20 percent if the corporate taxpayer (1) discloses to the National Office of the Internal Revenue Service within 30 days of the closing of the tax shelter transaction appropriate documents describing the transaction, (2) files a statement with its tax return verifying that such disclosure has been made, and (3) provides adequate disclosure on its tax returns as to the book/tax differences resulting from the corporate tax shelter item for the taxable years in which the tax shelter transaction applies. The reasonable cause exception of section 6664(c) would be eliminated for any item attributable to a corporate tax shelter.

For this purpose, a corporate tax shelter would be any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code).

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

The Secretary may prescribe regulations necessary to carry out the purposes of this provision.

The proposal would be effective for transactions occurring on or after the date of first committee action.



## DENY CERTAIN TAX BENEFITS TO PERSONS AVOIDING INCOME TAX AS A RESULT OF TAX AVOIDANCE TRANSACTIONS

### Current Law

Under section 269, if a person acquires (directly or indirectly) control of a corporation, or a corporation acquires (directly or indirectly) carryover basis property of a corporation not controlled (directly or indirectly) by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, the Secretary may disallow such tax benefit either in whole or in part to the extent necessary to eliminate such evasion or avoidance of income tax. For purposes of this rule, control means the ownership of 50 percent of the corporation's stock (by vote or value). The rule applies also in the case of a qualified stock purchase by one corporation of another corporation, in the event that the acquiring corporation does not elect to treat the stock purchase as an asset acquisition, and where the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date, the principal purpose of which is to secure the benefit of a deduction, credit, or other allowance.

Tax benefits also can be disallowed when those benefits are generated in transactions that lack economic substance and undermine the purposes of the Code. *Sheldon v. Comm'r*, 94 T.C. 738 (1990). Treasury has exercised its general regulatory authority to promulgate anti-avoidance rules in specific contexts, including rules incorporating business purpose and economic substance standards. *See, e.g.*, Treas. Reg. section 1.701-2; Notice 98-5, 1998-3 I.R.B. 3.

### Reasons for Change

The Administration is concerned about the proliferation of corporate tax shelter activity that allows a direct or indirect corporate participant to obtain a tax benefit that the participant otherwise did not possess in a tax avoidance transaction. The current law anti-avoidance provision may not be sufficient to address many current corporate tax shelter schemes. First, the provision only applies to the acquisition of control of a corporation or the acquisition of carryover basis property. In addition, although tax evasion or avoidance might be the most significant factor motivating an acquisition or liquidation, it is difficult from an administrative standpoint to contest a taxpayer's assertion that the transaction had another more significant purpose.

Furthermore, some taxpayers take aggressive positions that they are entitled to a tax benefit even in circumstances in which there is little or no expected pre-tax economic profit from a structure. The proposal would clarify that tax benefits arising from tax avoidance transactions would be disallowed. The Administration proposes to expand the anti-avoidance provision to better address the types of transactions that the Administration believes are abusive.

## **Proposal**

The proposal would expand the scope of the anti-avoidance rule by adding a provision authorizing the Secretary to disallow a deduction, credit, exclusion or other allowance obtained in a tax avoidance transaction. For purposes of this proposal, "tax avoidance transaction" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. No inference is intended regarding the treatment of such transactions under current law.

The proposal would apply to transactions entered into on or after the date of first committee action.

## **DENY DEDUCTIONS FOR CERTAIN TAX ADVICE AND IMPOSE AN EXCISE TAX ON CERTAIN FEES RECEIVED**

### **Current Law**

Buyers of corporate tax shelter advice generally may deduct the fees paid for such advice as an ordinary and necessary business expense.

### **Reasons for Change**

The Administration has become increasingly concerned with the prevalence of corporate tax shelters and thus wants to impose impediments to the purchase, promotion and sale of corporate tax shelters. Further, the Administration does not believe that payments made for the purchase and implementation of corporate tax shelter schemes should be treated as ordinary and necessary business expenses.

### **Proposal**

The proposal would deny a deduction to the corporate participant in a tax avoidance transaction for fees paid or incurred in connection with the purchase and implementation of corporate tax shelters and the rendering of tax advice related to corporate tax shelters. The proposal also would impose a 25 percent excise tax on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to the underwriting or other fees) and the rendering of tax advice related to corporate tax shelters. This proposal would not apply to expenses incurred with respect to representing the taxpayer before the IRS or a court. If a taxpayer claims a deduction that otherwise would be denied under this proposal, the amount of deduction could be subject to the Administration's proposed new substantial understatement penalty. For purposes of this proposal, "corporate tax shelter" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty.

The proposal would be effective for fees paid or incurred, and fees received, on or after the date of first committee action.

## **IMPOSE EXCISE TAX ON CERTAIN RESCISSION PROVISIONS AND PROVISIONS GUARANTEEING TAX BENEFITS**

### **Current Law**

Because taxpayers entering into corporate tax shelter transactions know that such transactions are risky, particularly because the expected tax benefits are not justified economically, purchasers of corporate tax shelters often --

- (1) require a rescission clause that requires the seller of the shelter or a counterparty to unwind the transaction and make the taxpayer whole financially if there is a change in or clarification of law that interferes with the successful completion of the transaction,
- (2) require a guarantee of tax benefits necessitated not by a change or misstatement of the facts but by a change in or clarification of the law (to distinguish this from a normal representation and warranty clause), or
- (3) enter into insurance arrangements with third parties to guarantee the tax benefits.

The tax treatment of payments under these arrangements depends upon the nature of the payments.

### **Reasons for Change**

The Administration has become increasingly concerned with the prevalence of corporate tax shelters and is concerned that provisions that insulate the purchaser from risk encourage participation in tax shelter activity. The Administration wants to impose impediments to the purchase, promotion and sale of corporate tax shelters by taking away the benefit of provisions that insulate the purchaser from risk.

### **Proposal**

The proposal would impose on the corporate purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment under a tax benefit protection arrangement at the time the arrangement is entered into. For this purpose, a tax benefit protection arrangement would include a rescission clause, guarantee of tax benefits arrangement or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction). The maximum payment under the arrangement would be the aggregate amount the taxpayer would receive if the tax benefits were denied. For example, if a taxpayer purchases for \$100 protection against the risk that the tax benefits derived from a transaction will not be realized and the agreement values the tax benefits at \$10,000, the taxpayer would be subject to an excise tax of \$2,500, even if it is later determined that only \$5,000 of the tax benefits from the transaction were denied. For purposes of this proposal, "corporate tax shelter" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty.

The Secretary would have regulatory authority to provide that arrangements entered into in connection with specified transactions are not subject to the proposal.

The proposal would apply to arrangements entered into on or after the date of first committee action.

## **PRECLUDE TAXPAYERS FROM TAKING TAX POSITIONS INCONSISTENT WITH THE FORM OF THEIR TRANSACTIONS**

### **Current Law**

In general, if a taxpayer enters into a transaction in which the economic substance and legal form of the transaction are different (and, thus, provide for different Federal income tax consequences), the taxpayer may take the position that, notwithstanding the form of the transaction, the substance is controlling for determining the Federal income tax consequences of the transaction. To successfully assert that the substance, and not the form, of the transaction controls the Federal income tax consequences, taxpayers must meet a relatively high standard of proof. Depending on the jurisdiction in which the taxpayer resides, the taxpayer will be required to show that the substance of the transaction is indeed different from its form through either proof that would alter the construction of the agreement or render it unenforceable (the so-called "Danielson rule") or strong proof (something more than a preponderance of the evidence and something less than the Danielson rule). See, e.g., Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Danielson v. Commissioner, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986).

Under section 385(c), an issuer's characterization of an interest in a corporation as debt or equity is binding on the issuer and all holders of such interests, unless the holder discloses that it is treating the interest in a manner inconsistent with the issuer's characterization. Under section 1060(a), if, in connection with an applicable asset acquisition, the transferor and transferee agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that the allocation (or fair market value) is not appropriate.

### **Reasons for Change**

Because a taxpayer has control over the form of its transactions, it is appropriate to impose restrictions on the taxpayer's ability to argue against the form it has chosen. In addition, many taxpayers enter into transactions in which the substance is different from the form in order to arbitrage U.S. and foreign tax and regulatory laws. In transactions involving a taxable and tax indifferent party, the taxable party may believe it has even greater freedom to disavow the form of the transaction because such recharacterization would have no effect upon the tax indifferent party.

### **Proposal**

The proposal would generally provide that a corporate taxpayer would be precluded from taking any position (on any return or refund claim) that the Federal income tax treatment of a transaction is different from that dictated by its form if a tax indifferent party has a direct or indirect interest in such transaction. This rule would not apply (i) if the taxpayer discloses the inconsistent position on a timely filed original Federal income tax return for the taxable year that includes the date the transaction is entered into; (ii) to the extent provided in regulations, if reporting the substance of

the transaction more clearly reflects the income of the taxpayer; or (iii) to certain transactions (such as publicly available securities lending and sale-repurchase transactions) identified in regulations. For this purpose, the form of a transaction is to be determined based on all facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A tax indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.) The Secretary would have the authority to prescribe regulations to carry out the purposes of the rule, including regulations that would define the “form” of a transaction. Nothing in the proposal would prevent the Secretary from asserting the substance-over-form doctrine or imposing any applicable penalties. No inference is intended as to what extent a corporate taxpayer may disavow the form of its transactions under current law.

The proposal would be effective for transactions entered into on or after the date of first committee action.

## **TAX INCOME FROM CORPORATE TAX SHELTERS INVOLVING TAX-INDIFFERENT PARTIES**

### **Current Law**

The Federal income tax system has many participants who are indifferent to tax consequences, e.g., foreign persons, tax-exempt organizations, and Native American tribal organizations. Foreign persons are subject to U.S. Federal income tax on a net basis on income that is effectively connected to a U.S. trade or business (ECI) and on a gross basis on income that is fixed or determinable annual or periodic (FDAP). Tax-exempt organizations (including pension plans and charitable organizations) are subject to Federal income tax only on income that is unrelated (UBTI) to the organization's exempt purpose.

### **Reasons for Change**

Many corporate tax shelters involve a timing mismatch or separation of income or gains from losses or deductions that is exploited through the use of tax indifferent parties. In these transactions, the tax indifferent party absorbs the income or gain generated in the transaction, leaving the corresponding loss or deductions to the taxable corporate participants. Tax indifferent parties often agree to engage in such transaction in exchange for an enhanced return on investment or for an accommodation fee. Corporate taxpayers should not be entitled to buy the special tax status of tax indifferent parties. Imposing a tax on the income allocated to tax indifferent parties should limit the sale of their special tax status and, thus, their participation in corporate tax shelters.

### **Proposal**

The proposal would provide that any income allocable to a tax indifferent party with respect to a corporate tax shelter is taxable to such party. The tax on the income allocable to the tax indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. All other participants of the corporate tax shelter (i.e., any participant other than the tax indifferent party in question) would be jointly and severally liable for the tax. For this purpose, a corporate tax shelter would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. A tax indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.)

In the case of a tax-exempt organization, the income would be characterized as UBTI. In the case of a domestic corporation with expiring loss or credit carryovers, tax would be computed without regard to such losses or credits. In the case of a foreign person, tax on the income or gain allocable to such person would first be determined without regard to any exclusion or exception (provided in a treaty or otherwise) and any such income or gain that is not U.S. source FDAP would be treated as ECI, regardless of its source. If the foreign person properly claimed the benefit of a treaty, however, the tax otherwise owing by such person would be collected from the other participants who are not



exempt from U.S. tax. Similarly, in the case of a Native American tribal organization, the tax on the income allocable to such person would be determined without regard to any exclusion or exception; however, the tax would be collected only from the participants who are not exempt from U.S. tax, rather than the tribal organization.

The proposal would be effective for transactions entered into on or after the date of first committee action.

## **REQUIRE ACCRUAL OF TIME VALUE ELEMENT ON FORWARD SALE OF CORPORATE STOCK**

### **Current law**

A corporation generally does not recognize gain or loss on the issuance or repurchase of its own stock. Thus, a corporation does not recognize gain or loss on the forward sale of its own stock. A corporation sells its stock forward by agreeing to issue its stock in the future in exchange for consideration to be paid in the future.

Although a corporation does not recognize gain or loss on the issuance of its own stock, a corporation does recognize interest income upon the current sale of stock for deferred payment.

### **Reason for Change**

There is little substantive difference between a corporate issuer's current sale of its stock for deferred payment and an issuer's forward sale of the same stock. The only difference between the two transactions is the timing of the stock issuance. In a current sale, the stock is issued at the inception of the transaction, while, in a forward sale, the stock is issued at the time the deferred payment is received. In both cases, a portion of the deferred payment economically compensates the corporation for the time-value of the deferred payment. It is inappropriate to treat these two transactions differently.

### **Proposal**

The proposal would require a corporation that enters into a forward contract to issue its stock to treat a portion of the payment on the forward issuance as a payment of interest.

The proposal would be effective for forward contracts entered into on or after the date of first committee action.

## **MODIFY TREATMENT OF BUILT-IN LOSSES AND OTHER ATTRIBUTE TRAFFICKING**

### **Current Law**

Under current law, a taxpayer that becomes subject to U.S. taxation may take the position that it determines its beginning bases in its assets under U.S. tax principles as if the taxpayer had historically been subject to U.S. taxation. Other tax attributes are computed similarly. Because the Code does not explicitly prevent the importation of beneficial tax attributes when non-U.S. taxpayers (such as tax-exempt organizations or foreign taxpayers) or their assets become subject to U.S. taxing jurisdiction, a taxpayer may “import” built-in losses or other favorable tax attributes incurred outside U.S. taxing jurisdiction to offset income or gain that would otherwise be subject to U.S. tax. For example, taxpayers can shelter income from U.S. tax by acquiring built-in losses or other built-in items such as built-in deductions, foreign tax credits and deficits in earnings and profits that were generated outside the U.S. taxing jurisdiction. Conversely, taxpayers may “import” built-in gains to their detriment by acquiring low basis high value assets or other unfavorable tax attributes in transactions in which there is a carryover of attributes (*e.g.*, transactions described in sections 332, 351 and 368, contributions to a U.S. trade or business, or the change to U.S. residency by a nonresident alien). Many taxpayers, however, trigger built-in gains on assets for U.S. tax purposes immediately prior to importing an asset, thereby obtaining a step-up in basis without a resulting U.S. tax, or make a section 338 election if such election is beneficial and available.

The Code provides a number of rules to discourage U.S. taxpayers from obtaining beneficial tax attributes accrued by another. *See, e.g.*, sections 269 and 381 through 384. For various reasons, however, those provisions are not effective at preventing the types of trafficking described above.

In addition, in certain circumstances under current law, tax histories of non-U.S. taxpayers that accrued before they enter the U.S. taxing jurisdiction must be recreated. For example, a taxpayer is required to recreate, under U.S. tax principles, bases and other tax histories (such as earnings and profits histories) that occurred while outside of the U.S. taxing jurisdiction, even if adequate records have not been kept and the histories date back many years.

### **Reasons for Change**

Current law does not properly reflect the U.S. taxing interest when attributes are imported into the United States. This can lead to purposeful tax avoidance by taxpayers. For example, by acquiring tax attributes, U.S. taxpayers may manipulate foreign tax credit positions or avoid income tax, capital gains tax or subpart F inclusions. Non-U.S. taxpayers investing in the United States may avoid U.S. tax on U.S. operations that would otherwise be subject to tax (*e.g.*, operations through U.S. subsidiaries or as income effectively connected with a U.S. trade or business (ECI)). Similar issues can arise in transactions involving organizations exempt from tax under section 501 or other tax-exempt entities. In addition, as described above, the carryover of tax attributes can lead to unfair results to taxpayers in other contexts. Such results should be minimized. A taxpayer should not obtain the benefit of favorable tax attributes for U.S. purposes in circumstances where such taxpayer has not

previously been subject to U.S. taxing jurisdiction. The same may be said of unfavorable tax attributes.

Current law also creates unnecessary administrative complexity for both taxpayers and the government when attributes are carried over. Tax histories frequently span long periods of times, including periods in which the recreation of attributes under U.S. principles may be difficult or impossible, and may require costly bases and earnings and profits studies of questionable accuracy. The proposal represents a simplification from the current administrative difficulty of recreating tax histories for entities and assets when they had little or no U.S. nexus.

The proposal would address these concerns and provide a rule that is fair to both taxpayers and the government by limiting the importation of tax attributes while reducing the administrative and compliance burdens of current law.

### **Proposal**

The proposal would provide taxpayers with a “fresh start” by eliminating tax attributes (including built-in items) and marking-to-market bases, as applicable, when an entity or an asset becomes “relevant” for U.S. tax purposes. An entity would become relevant for U.S. tax purposes when (i) a “tax-exempt entity” becomes a “taxable U.S. entity,” or (ii) a foreign corporation that is not a controlled foreign corporation (CFC) but is a “taxable U.S. entity” becomes a CFC or a U.S. person.

For these purposes, a tax-exempt entity would include an entity that is exempt from tax under section 501, a Native American tribal organization, a nonresident alien, and a foreign corporation that is not a member of a “qualified group” under section 902(b)(2). A taxable U.S. entity would be a U.S. person (as defined in section 7701(a)(30) other than an organization that is exempt from tax under section 501), a foreign corporation that is part of a qualified group, or a CFC. Thus, for example, the proposal would apply to a section 501 organization that loses its tax-exempt status, a tax-exempt foreign corporation that domesticates in an F reorganization, a nonresident alien that becomes a U.S. resident, a tax-exempt foreign corporation that becomes a taxable U.S. entity because of stock acquisitions by a U.S. person, or a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) (a “10/50 company”) that becomes a CFC or U.S. corporation. The proposal would provide the Secretary with authority to prescribe regulations in which certain tax-exempt entities would not be subject to this rule, such as in the case of a section 501(c)(12) corporation that changes from taxable to tax-exempt status from year-to-year based on income earned.

The proposal would provide analogous rules to those described above for the transfer of assets and liabilities. Thus, for example, assets that are transferred from a tax-exempt entity to a taxable U.S. entity (such as in a section 351 transaction) or to a business unit that generates unrelated business taxable income (UBTI) or ECI, or from a 10/50 company to a CFC, U.S. resident, or a business unit that generates UBTI or ECI would be marked-to-market at the time of the transfer. Special valuation rules would be provided with respect to the transfer of intangible assets. The proposal would provide

the Secretary with authority to identify the circumstances under which transfers to partnerships and transfers of partnership interests would be subject to the rule.

A special rule would be provided to exclude items that are related to UBTI or ECI prior to the time an asset or its owner becomes relevant, as well as for personal assets in the case of a nonresident alien who becomes a U.S. resident. Special rules would also be provided for U.S. shareholders of a foreign corporation whose assets were marked to market and attributes eliminated, where such U.S. shareholders were shareholders of the foreign corporation both before and after the mark. These rules would preserve tax attributes to pre-existing U.S. shareholders through shareholder level accounts that would not affect the attributes of other shareholders.

The proposal would provide the Secretary with authority to prescribe regulations to carry out the purposes of the proposal, including regulations governing the proper treatment of deficits that existed in an entity prior the elimination of attributes and related foreign tax credits, and the proposal's interaction with section 367(b) (and the regulations thereunder) and the passive foreign investment company regime. The proposal would also provide the Secretary with authority to prescribe regulations necessary to prevent trafficking in favorable tax attributes involving foreign corporations to the extent not specifically addressed by the statute. This would include, for example, trafficking in favorable attributes among CFCs.

The proposal would be effective for transactions entered into on or after the date of enactment. No inference would be intended as to the treatment under present law of transactions that purport to result in the use for U.S. tax purposes of tax attributes arising outside the U.S. taxing jurisdiction.

## **MODIFY TREATMENT OF ESOP AS S CORPORATION SHAREHOLDER**

### **Current Law**

Pursuant to a provision of the Small Business Job Protection Act of 1996, an employee stock ownership plan (ESOP) may be a shareholder in an S corporation. Under that provision, any income of the S corporation that flowed through to the ESOP (or gain on the sale of S corporation shares by the ESOP) was treated as unrelated business income and subject to tax at the ESOP level. A provision of the Taxpayer Relief Act of 1997 repealed this unrelated business income rule; thus, S corporation income allocable to an ESOP is not subject to current taxation, but is deferred until distributions are made to the ESOP beneficiaries.

### **Reasons for Change**

The 1997 Act provision repealed the UBIT rule because it was thought that the 1996 Act provision unfairly taxed S corporation earnings twice --once when earned and again when distributed. However, this rule violates the general principle that business income, including S corporation income, should be subject to tax when the income is earned. This allows significant deferral, and possible avoidance, of tax on S corporation income to the extent the S corporation is owned by an ESOP.

### **Proposal**

The proposal would repeal the 1997 Act provision and would restore the rule that treats any income of an S corporation that flowed through to the ESOP (or gain on the sale of S corporation shares by the ESOP) as unrelated business income subject to current tax at the ESOP level. An ESOP would be allowed a deduction for distributions made to its participants and beneficiaries. This deduction would only apply to the extent that distributions exceed undistributed amounts that were previously not subject to unrelated business income tax (i.e., earnings in taxable years after 1997 and before the effective date of the proposal, reduced by distributions made in taxable years after 1997). Net operating loss rules would be modified to the extent necessary in order for ESOP distribution deductions that exceed net unrelated business taxable income to be carried back two years or forward 20 years to offset S corporation income recognized pursuant to this rule.

The proposal would be effective for taxable years beginning on or after the date of first committee action. In addition, the proposal would be effective for acquisitions of S corporation stock by an ESOP on or after that date and for S corporation elections made on or after that date.

**LIMIT TAX-FREE LIQUIDATIONS OF U.S. SUBSIDIARIES  
OF FOREIGN CORPORATIONS IN ORDER TO PRESERVE THE IMPOSITION OF  
U.S. TAX ON THE DISTRIBUTED EARNINGS**

**Current Law**

The income of a U.S. corporation is taxed at the corporate level when earned and again at the shareholder level when distributed as a dividend. U.S. tax rules impose withholding tax on dividend distributions of U.S. subsidiaries to foreign corporations consistent with the taxation of income at the shareholder level. However, U.S. withholding tax generally is not imposed on a distribution of U.S. subsidiary earnings in a complete liquidation under section 332 because that provision treats any such distribution as a non-taxable payment in exchange for the stock.

**Reasons for Change**

In order to avoid the withholding tax that would otherwise apply to a dividend distribution, some foreign corporations carry out serial liquidations by establishing U.S. holding companies to receive tax-free dividends from operating subsidiaries, liquidating the holding companies and then re-establishing the holding companies. Through this means, subsidiary earnings repeatedly are distributed in tax-free liquidating distributions to foreign corporations and the operating subsidiaries producing the earnings continue in operation. Foreign corporations similarly may be able to avoid the branch profits tax through terminations of U.S. businesses conducted in branch form.

**Proposal**

The proposal generally would treat as a dividend distribution any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation if the U.S. holding company subsidiary of the foreign corporation was in existence for less than 5 years. A coordination rule would ensure that a similar result obtains on the termination of a U.S. branch of a foreign corporation.

The proposal would be effective for liquidations and terminations occurring on or after the date of enactment.

## **PREVENT CAPITAL GAINS AVOIDANCE THROUGH BASIS SHIFT TRANSACTIONS INVOLVING FOREIGN SHAREHOLDERS**

### **Current Law**

A distribution in redemption of stock is treated as a dividend, rather than as a sale of stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The rules for determining whether a shareholder's proportionate interest in the distributing corporation has been meaningfully reduced include reference to the option attribution rules of section 318(a)(4).

Under Treasury regulations, if an amount received in redemption of stock is treated as a distribution of a dividend, the basis of the remaining stock generally is increased to reflect the basis of the stock redeemed. The basis of the remaining stock is not increased, however, to the extent that the basis of the redeemed stock was reduced or eliminated pursuant to section 1059.

Section 1059 requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock by the nontaxed portion of the dividend. The nontaxed portion of the dividend effectively equals the amount of the dividend that is offset by the dividends received deduction. A dividend resulting from a non pro rata redemption or a liquidation is an extraordinary dividend, as is a dividend resulting from a redemption that is treated as a dividend due to options being counted as stock ownership.

### **Reasons for Change**

Taxpayers have attempted to offset capital gains by generating artificial capital losses through basis shift transactions involving foreign shareholders. Similar transactions involving dividends to domestic shareholders were addressed by amendments to section 1059 in the Taxpayer Relief Act of 1997.

### **Proposal**

For purposes of section 1059, the nontaxed portion of the dividend would include the amount of the dividend that is not subject to current U.S. tax. In the event that a treaty between the United States and a foreign country reduces the rate of U.S. tax imposed on the dividend (and the dividend is not otherwise subject to U.S. tax), the nontaxed portion would be the amount of the dividend multiplied by a fraction the numerator of which is the tax rate applicable without reference to the treaty less the tax rate applicable under the treaty and the denominator of which is the tax rate applicable without reference to the treaty. Similar rules would apply in the event that the foreign shareholder is not a corporation. No inference is intended as to the treatment of such transactions under current law.

The proposal would be effective for distributions on or after the date of first committee action.



## **LIMIT INAPPROPRIATE TAX BENEFITS FOR LESSORS OF TAX-EXEMPT USE PROPERTY**

### **Current Law**

Under current law, certain property leased to governments, tax-exempt organizations, or foreign persons is considered to be “tax-exempt use property.” There are a number of restrictions on the ability of lessors of tax-exempt use property to claim tax benefits from transactions related to the tax-exempt use property. For example, a lessor of tax-exempt use property cannot depreciate the property using an accelerated method of depreciation. Instead, the lessor must depreciate the property using a straight-line method over a term that is the longer of class life or 125 percent of the lease term. Under Section 469, an individual generally may not deduct net losses from activities (including leases) in which the taxpayer does not materially participate. Any losses disallowed may be carried forward to offset taxable income generated from such activities.

### **Reasons for Change**

The Administration is concerned that certain leasing transactions involving tax-exempt use property are being used to generate inappropriate tax benefits. These transactions are structured to take advantage of mismatches between reported income and expense and the tax-exempt status of an accommodating party in order to generate significant tax benefits for a U.S. lessor which can shelter other income.

### **Proposal**

The proposal would apply principles similar to those that apply under Section 469 to leases involving tax-exempt use property. Thus, a lessor of tax-exempt use property would not be able to recognize a net loss from a leasing transaction involving tax-exempt use property during the lease term. A lessor would be able to carry forward a net loss from a leasing transaction and use it to offset net gains from the transaction in subsequent years. In the year the leasing transaction terminates, the lessor would be able to recognize any previously unrecognized net loss.

A special rule would define a leasing transaction to include the lease itself and all related agreements (i.e., sales, loans, and option agreements) entered into by the lessor with respect to the lease of the tax-exempt use property. Thus, for example, if a taxpayer purchased property from a foreign government, leased the property to the foreign government, financed the purchase with a nonrecourse loan from a bank, and entered into an option to sell the property to a third party, each of these individual transactions would be considered part of the overall leasing transaction.

The proposal would be effective for leasing transactions entered into on or after the date of enactment.

## **PREVENT MISMATCHING OF DEDUCTIONS AND INCOME INCLUSIONS IN TRANSACTIONS WITH RELATED FOREIGN PERSONS**

### **Current Law**

Section 163(e)(3) provides that if any debt instrument having original issue discount (OID) is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid. This general rule does not apply, however, to the extent that the OID is effectively connected with the conduct by such foreign related person of a trade or business within the United States (unless such OID is exempt from taxation or is subject to a reduced rate of taxation under a treaty obligation). The general rule also is modified so that a deduction is allowed when the OID is includable in the income of a foreign personal holding company (FPHC), controlled foreign corporation (CFC) or passive foreign investment company (PFIC). Section 267 and the regulations thereunder apply similar rules to other expenses and interest owed to related foreign persons. The regulations under section 267(a)(3) contain a general rule similar to that of section 163(e)(3), but those regulations generally do not apply to OID deductions. Moreover, those regulations contain a special rule similar to the rule under section 163(e)(3) applicable to amounts deductible when the corresponding amounts are includable in the income of a FPHC, CFC or PFIC.

### **Reasons for Change**

The Treasury has learned of certain structured transactions (involving both U.S. payors and U.S.-owned foreign payors) designed to allow taxpayers inappropriately to take advantage of the current rules by accruing deductions to related FPHCs, CFCs or PFICs, without the U.S. owners of such related entities taking into account for U.S. tax purposes an amount of income appropriate to the accrual. This results in an improper mismatch of deductions and income.

### **Proposal**

The proposal would amend sections 163(e)(3) and 267(a)(3). It would provide that the deductions for amounts accrued but unpaid (whether by U.S. or foreign persons) to related foreign CFCs, PFICs or FPHCs would be allowable only to the extent the amounts accrued by the payor are, for U.S. tax purposes, reflected in the income of the direct or indirect U.S. owners of the related foreign person. An exception would be provided for amounts accrued under circumstances where payment of the amount accrued occurs within a short period after accrual and the transaction giving rise to the payment is entered into by the payor in the ordinary course of a business in which the payor is predominantly engaged. In addition, the Secretary would be granted regulatory authority to provide exceptions to these rules.

The proposal would be effective for payments accrued on or after the date of first committee action. No inference is intended as to the treatment of such payments under current law.

## **RESTRICT BASIS CREATION THROUGH SECTION 357(c)**

### **Current Law**

Section 351 provides that no gain or loss shall be recognized if property is exchanged solely for stock of a controlled corporation. If the sum of the amount of liabilities assumed by the transferor, plus the amount of the liabilities to which the transferred property is subject, exceeds the total adjusted basis of the property transferred pursuant to a section 351 exchange, the transferor must recognize gain from the sale or exchange of the property (with certain exceptions) pursuant to section 357(c).

The basis of property transferred equals the transferor's basis in such property increased by the amount of gain recognized by the transferor, including section 357(c) gain.

### **Reasons for Change**

Where a recourse liability is secured by multiple assets, the tax treatment is unclear under current law whether a transfer of one asset where the transferor remains liable is a transfer "subject to" the liability. As a result, many taxpayers lack the certainty necessary to engage in legitimate transactions while others have structured transactions to take advantage of different interpretations. For example, if a foreign transferor transfers an asset that partially secures a line of credit, taxpayers have taken the position that gain would be computed under section 357(c) by treating the entire liability as an amount realized and the transferee's basis in the asset would be increased accordingly. Alternatively, under this interpretation, if a transferor transfers the assets securing a single liability to several different subsidiaries, taxpayers have taken the position that each asset has a basis increased by the entire liability. Similar issues arise with respect to nonrecourse liabilities.

### **Proposal**

The distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally would be eliminated. Except as provided in regulations, recourse liability or any portion thereof would be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed and is expected to satisfy the liability or portion thereof (whether or not the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be treated as expected to satisfy such liability or portion thereof. Except as provided in regulations, a nonrecourse liability would be treated as having been assumed by the transferee of any asset subject to the liability with a limitation. The amount treated as assumed would be reduced by the amount of the liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee, and is expected to satisfy, up to the fair market of such other assets (determined without regard to section 7701(g)).

In determining whether any person has agreed and is expected to satisfy a liability, all facts and circumstances would be considered. In any case where the transferee does agree to satisfy a liability,

the transferee would be treated as expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under section 357, the increase would not cause the basis to exceed the fair market value of the property (determined without regard to section 7701(g)). In addition, if gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that is also secured by property not transferred to the corporation, and if no person is subject to U.S. tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain so treated as recognized would be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to section 7701(g)) of all assets subject to such nonrecourse liability.

The Treasury Department would have authority to prescribe any regulations which may be necessary to carry out the purposes of the provision. Where appropriate, the Treasury Department would also be authorized to prescribe regulations which provide that the manner in which a liability is treated as assumed under this proposal is applied elsewhere in the Code.

No inference regarding the tax treatment under current law is intended by this proposal.

The proposal would be effective for transfers on or after October 19, 1998.

## **MODIFY ANTI-ABUSE RULES RELATED TO ASSUMPTION OF LIABILITIES**

### **Current Law**

No gain or loss is recognized if property is exchanged for stock of a controlled corporation. The transferor may recognize gain to the extent other property (“boot”) is received by the transferor. The assumption of liabilities by the transferee generally is not treated as boot received by the transferor. The assumption of a liability is treated as boot to the transferor, however, “[i]f, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer...was a purpose to avoid Federal income tax on the exchange, or...if not such purpose, was not a bona fide business purpose.” Thus, this exception requires that the principal purpose of having the transferee assume the liability was the avoidance of tax on the exchange. The transferor’s basis in the stock of the transferee received in the exchange is reduced by the amount of any liability assumed, but generally increased in the amount of any gain recognized by the transferor on the exchange. Similar rules apply in connection with certain tax-free reorganizations.

### **Reasons for Change**

The anti-abuse rule related to the assumption of liabilities is inadequate to address the avoidance concerns that underlie the provision, especially given the high standard before it is applicable. The provision rarely applies because the tax avoidance is made possible by the exchange, but the exchange itself is not the tax avoidance transaction.

In one inappropriate transaction, taxpayers transfer assets with a fair market value basis in exchange for preferred stock and the transferee’s assumption of a contingent liability that is deductible in the future but easily valued currently. The transferor claims an artificially high basis in the stock of the transferee corporation because the payment of a liability that would give rise to a deduction generally is not taken into account in determining the amount of liabilities assumed and thus does not reduce the taxpayer’s basis. Thus, the transferor can accelerate the deduction by selling or exchanging the stock at a loss, and the transferee might take the position that it is entitled to deduct payments on the liability, effectively duplicating the deduction attributable to the same liability.

### **Proposal**

The Administration proposes to delete the limitation that the assumption of liabilities anti-abuse rule only applies to tax avoidance on the exchange itself, and to change “the principal purpose” standard to “a principal purpose”. A taxpayer may have “a principal purpose” of tax avoidance even though it is outweighed by other purposes (taken together or separately). In addition, a modification to the basis rule would be made to require a decrease in the transferor’s basis in the transferee’s stock when a liability, the payment of which would give rise to a deduction, is treated as boot under the anti-abuse rule.

This proposal is effective for assumptions of liabilities on or after the date of first committee action.

## **MODIFY CORPORATE-OWNED LIFE INSURANCE (COLI) RULES**

### **Current Law**

In general, no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract or endowment contract, and Federal income tax generally is deferred with respect to the earnings under an annuity contract. In addition, amounts received under a life insurance contract paid by reason of death of the insured are excluded from gross income.

Interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts generally is not deductible, unless the insurance contract insures the lives of a key person of a business. A key person includes a 20 percent owner of the business, as well as a limited number of the business' officers or employees. However, this interest disallowance rule applies to businesses only to the extent that the indebtedness can be traced to a life insurance, endowment or annuity contract.

In addition, the interest deductions of a business other than an insurance company are reduced under a proration rule if the business owns or is a direct or indirect beneficiary with respect to certain life insurance, endowment or annuity contracts. This proration rule generally does not apply if the contract covers an individual who is a 20 percent owner of the business or an officer, director or employee of such business. This proration rule also does not apply if the contract is a joint life policy covering a 20 percent owner of the business and his or her spouse.

Special proration rules apply to life insurance companies and property casualty insurance companies if such insurance companies own or are direct or indirect beneficiaries under the same types of life insurance, endowment and annuity contracts. Under the special life insurance company proration rules, the life insurance company's reserve and policyholder dividend deductions are reduced to the extent that such reserves or dividends are funded by the inside buildup on certain life insurance, endowment and annuity contracts. Under the special property casualty insurance company rules, the losses incurred deductions of the property casualty insurance company are reduced by 15 percent of the inside buildup on certain life insurance, endowment and annuity contracts.

### **Reasons for Change**

Leveraged businesses can still fund deductible interest expenses with tax-exempt or tax-deferred inside buildup on life insurance, endowment or annuity contracts insuring certain types of individuals. For example, banks, commercial credit companies and other leveraged businesses frequently invest in single premium or other investment-oriented insurance policies covering the lives of their employees, officers, directors or owners. These entities do not take out policy loans or other indebtedness that is secured or otherwise traceable to the insurance contracts. Instead, they borrow from depositors or other lenders, or issue bonds.

Similar tax arbitrage benefits result when insurance companies invest in certain insurance contracts that cover the lives of their employees, officers, directors or 20 percent shareholders. Life

insurance companies can still fund deductible reserves or policyholder dividends with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners. Similarly, property casualty insurance companies can still fund deductible loss reserves with tax-exempt or tax-deferred investment income on insurance contracts with respect to their employees, officers, directors or 20 percent owners.

**Proposal**

The proposal would repeal the exception under the COLI proration rules for contracts covering employees, officers or directors, other than 20 percent owners of the business that is the owner or beneficiary of an annuity, endowment or life insurance contract. The proposal would be effective for taxable years beginning after the date of enactment.

## **Financial Products**

### **REQUIRE BANKS TO ACCRUE INTEREST ON SHORT-TERM OBLIGATIONS**

#### **Current Law**

In 1984, Congress enacted section 1281, which required certain taxpayers including banks to accrue discount on short-term obligations. In the case of a governmental obligation, a taxpayer must accrue acquisition discount, which is the excess of the obligation's stated redemption price at maturity over the taxpayer's basis in the obligation. In the case of a non-governmental obligation, a taxpayer generally must accrue original issue discount, which is the excess of the obligation's stated redemption price at maturity over the issue price of the obligation. A short-term obligation is a debt instrument that has a term of one year or less.

In 1986, Congress clarified that taxpayers who were subject to accrual under section 1281, including banks, must accrue all interest on short-term obligations irrespective of whether the interest is stated as interest, is in the form of acquisition discount, or is original issue discount. Thus, under current law, a bank (regardless of its accounting method) must accrue stated interest, acquisition discount, original issue discount, or any combination thereof on short-term obligations that it holds.

#### **Reason for Change**

Recent court cases have held that banks that use the cash receipts and disbursements method of accounting do not have to accrue stated interest and original issue discount on short-term loans made in the ordinary course of the bank's business. The courts reasoned that because these loans were originated (not acquired), the "acquisition discount" rules of section 1281 did not apply. The Administration believes it is inappropriate to treat short-term obligations originated by a bank differently than short-term obligations purchased by the bank. In both cases, compensation for the use of money, whether in the form of stated interest, acquisition discount, or original issue discount, should be accrued.

#### **Proposal**

The proposal would clarify that banks must accrue all interest, original issue discount, and acquisition discount on short-term obligations, including loans made in the ordinary course of the bank's business, regardless of the bank's overall accounting method.

The proposal would be effective for obligations acquired (including those originated) on or after the date of enactment. No inference is intended regarding the tax treatment of obligations acquired (including those originated) prior to the effective date of the proposal.



## **REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT BY ACCRUAL METHOD TAXPAYERS**

### **Current Law**

Market discount is the excess, if any, of the principal amount of a debt instrument (or the adjusted issue price in the case of a debt instrument originally issued at a discount) over the holder's basis in the instrument immediately after acquisition. In general, if a holder acquires a debt instrument with market discount, the holder must treat any gain on the disposition of the debt instrument as ordinary income to the extent of accrued market discount. The holder generally determines the amount of accrued market discount by spreading the market discount ratably over the term of the instrument or electing to use constant yield principles. A special rule requires a holder to treat partial principal payments as ordinary income to the extent of economically accrued market discount. A holder may elect to include market discount in income as it accrues. Absent this election, a holder that uses an accrual method of accounting need not currently include market discount in income.

### **Reasons for Change**

In general, market discount arises when the market yield on a debt instrument exceeds its original yield. To a holder, market discount is economically equivalent to original issue discount, which the holder of a debt instrument must include in income on a current basis. The failure of current law to require holders to currently include market discount creates asymmetries between similarly situated holders. For example, a taxpayer that purchases a debt instrument with market discount is taxed more favorably than a similarly situated holder that purchases a debt instrument with original issue discount.

An accrual method taxpayer generally is required to include amounts in income as they are earned. Because market discount is earned over time, it is appropriate to require an accrual method taxpayer to accrue market discount over time.

In cases where the credit of the issuer is severely impaired, it may be inappropriate to treat the entire difference between the holder's basis and the principal amount as market discount. A significant portion of this difference, if realized, is more in the nature of a gain on an equity investment in the issuer than income from a lending transaction.

### **Proposal**

The proposal would require holders that use an accrual method of accounting to include market discount in income as it accrues. The holder's yield for purposes of determining and accruing market discount would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus 5 percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus 5 percentage points. The proposal would be effective for debt instruments acquired on or after the date of enactment.

## **LIMIT CONVERSION OF CHARACTER OF INCOME FROM CONSTRUCTIVE OWNERSHIP TRANSACTIONS WITH RESPECT TO PARTNERSHIP INTERESTS**

### **Current Law**

Gain or loss from the sale of a capital asset generally is treated as capital gain or loss. Generally, net capital gain (i.e., net long-term capital gain less net short-term capital loss) of an individual is subject to tax at preferential rates, and net capital losses in excess of \$3,000 are not deductible against ordinary income.

A partnership is not subject to Federal income tax. Instead, the partners include in their taxable income their distributive share of the partnership's income. Each partner includes its distributive share of the partnership's income on the last day of the partnership's taxable year, regardless of whether a distribution to the partner was made in that taxable year. Generally, the character of the partnership's income is determined at the partnership level and flows through as such to the partners. A sale of a partnership interest generally is treated as a sale of a capital asset.

### **Reasons for Change**

Because of their trading strategies, certain partnerships generate significant amounts of ordinary income and short-term capital gain. A partner in this type of partnership is required, under current law, to currently include significant amounts of ordinary income and short-term capital gain, even though the partner may not be entitled to actual distributions from the partnership for a number of years.

To avoid the current recognition of partnership income and to convert ordinary income and short-term capital gain into long-term capital gain, certain taxpayers have entered into derivatives transactions that are designed to give the taxpayer the "economics" of an equity interest in the partnership without giving the taxpayer an actual ownership interest in the partnership. These so-called "constructive ownership" transactions, although economically equivalent to current ownership, purportedly allow taxpayers to defer income and to convert ordinary income and short-term capital gain into long-term capital gain.

### **Proposal**

The proposal would limit the amount of long-term capital gain a taxpayer could recognize from a "constructive ownership" transaction with respect to a partnership interest. Under the proposal, gain from a constructive ownership transaction would be treated as ordinary income to the extent that the gain exceeds the "net underlying long-term capital gain" with respect to the transaction.

Under the proposal, 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 the partnership interest, (2) enters into a forward contract to acquire the partnership

interest, (3) is the holder of a call option and the grantor of a put option with respect to the partnership interest, or (4) enters into one or more transactions that have substantially the same effect.

The “net underlying long-term capital gain” with respect to the transaction is the aggregate amount of capital gain the taxpayer would have had had the taxpayer held a partnership interest directly during the term of the constructive ownership transaction.

To the extent gain is recharacterized as ordinary income under the proposal, an interest charge applies. For purposes of computing the interest charge, the taxpayer must assume that the ordinary gain was earned ratably over the term of the transaction. The taxpayer then computes the interest that would have been owed under section 6601 had these ratable amounts been taxable income in prior years.

The proposal allows taxpayers to elect mark-to-market treatment for constructive ownership transactions in lieu of applying the gain recharacterization and interest rule.

The proposal would be effective for gains recognized on or after the date of first committee action.

## MODIFY RULES FOR DEBT-FINANCED PORTFOLIO STOCK

### Current Law

A corporate taxpayer that receives a dividend from another corporation generally is allowed a dividends received deduction equal to a percentage of the dividend received. A special rule disallows a percentage of the corporate taxpayer's dividends received deduction on "debt-financed portfolio stock." This percentage is equal to the ratio of the average amount of portfolio indebtedness over the average amount of the adjusted bases of the portfolio stock during the period. In general, stock is "portfolio stock" if (1) it is held by a corporate taxpayer and (2) the corporate taxpayer holds less than 50 percent of the vote or value of the stock. Portfolio stock is considered to be debt-financed if the corporate taxpayer has incurred indebtedness that is directly attributable to its investment in the portfolio stock.

### Reason for Change

In general, a taxpayer should not be allowed to arbitrage the tax system by having tax-exempt income on one hand and related deductible expenses on the other. The current-law rules relating to debt-financed portfolio stock reflect this principle. However, the "directly attributable" standard of current law is too easily avoided. Under current law, a corporation can structure indebtedness that is designed to purchase or carry the portfolio stock but that does not meet the "directly attributable" standard.

### Proposal

The proposal would modify the standard for determining whether portfolio stock is debt-financed. Under the proposal, the percentage of portfolio stock considered to be debt-financed would be equal to the sum of (1) the percentage of stock that is directly financed by indebtedness, and (2) the percentage of remaining stock that is indirectly financed by indebtedness. The percentage that is indirectly financed by indebtedness would be determined by using a pro-rata concept similar to the one used in section 264(f) (pro-rata allocation of interest expense to life insurance policy cash values).

The proposal would be effective for portfolio stock acquired on or after the date of enactment.

## **MODIFY AND CLARIFY CERTAIN RULES RELATING TO DEBT-FOR-DEBT EXCHANGES**

### **Current Law**

Under current law, if a taxpayer issues a debt instrument in a debt-for-debt exchange, the taxpayer generally treats the difference between the issue price of the new debt instrument and the adjusted issue price of the old debt instrument as an adjustment to income in the year of the exchange. If the difference is positive (the issue price of the new instrument is greater than the adjusted issue price of the old instrument), the issuer has additional interest expense, commonly called “bond repurchase premium.” If the difference is negative (the issue price of the new instrument is less than the adjusted issue price of the old instrument), the issuer has income from the discharge of indebtedness.

Treasury regulations under section 163 provide a special rule in cases where neither the old nor the new debt instrument is publicly traded and there is bond repurchase premium. Under this rule, the bond repurchase premium is not deducted currently; rather, it is amortized over the term of the newly issued debt instrument in the same manner as if it were original issue discount.

### **Reason for Change**

In cases where either the old or the new debt instrument is publicly traded and the issuer’s cost of borrowing has declined, the issuer can inappropriately accelerate its future interest deductions by refinancing its outstanding debt through a debt-for-debt exchange. For financial accounting purposes, an issuer generally spreads the repurchase premium over the term of the new debt instrument.

### **Proposal**

The proposal would spread the issuer’s net deduction for bond repurchase premium in a debt-for-debt exchange over the term of the new debt instrument using constant yield principles. The proposal would apply only to issuers that use an accrual method of accounting.

The proposal would also clarify the measurement of the net income or deduction in cases where the new debt instrument is contingent and neither the new debt instrument nor the old debt instrument is publicly traded. In these cases, the net income or deduction from the exchange would be determined by comparing (1) the sum of the issue price of the new debt instrument and the fair market value of any contingent payments payable under the instrument, with (2) the adjusted issue price of the old debt instrument.

The proposal would also modify a holder’s tax consequences in a debt-for-debt exchange that is part of a corporate reorganization. Under the proposal, if a holder exchanges an old debt security for a new debt security as part of a reorganization, the holder would treat as taxable boot the excess, if any, of the issue price of the new security over the adjusted issue price of the old security. If either the old security or the new security is publicly traded, the amount of taxable boot would be capped at an amount equal to the excess of the issue price of the new security over the fair market value of the old security. The proposal would not otherwise affect holders of debt instruments.

The proposal would apply to debt-for-debt exchanges occurring on or after the date of enactment.

## **MODIFY AND CLARIFY STRADDLE RULES**

### **Current Law**

A “straddle” is a collection of two or more offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of the risk of loss from holding one position by reason of holding one or more other positions. A taxpayer that realizes a loss on one leg of a straddle during a taxable year may recognize the loss only to the extent the loss exceeds the unrecognized gain (if any) on the other legs of the straddle. If a loss is deferred under the straddle rules, the taxpayer must carry the loss forward to the succeeding taxable year. A taxpayer may not deduct net interest and carrying charges properly allocable to personal property which is part of a straddle. Instead, the taxpayer must capitalize these costs.

A direct ownership interest in an actively traded stock and a short sale of the same actively traded stock, although offsetting positions, do not constitute a straddle.

### **Reasons for Change**

If a taxpayer holds an appreciated position in personal property and enters into a structured financial transaction that substantially reduces the taxpayer’s risk of loss in the appreciated position, the two items are legs of a straddle. If the structured financial transaction includes a debt component, some taxpayers have taken the position that interest on this component is currently deductible because this interest expense was not incurred to purchase or carry the straddle. Some taxpayers have taken similar positions with respect to periodic payments made under the terms of structured financial transactions. It is inappropriate for a taxpayer to deduct expenses associated with the one leg of a straddle to the extent there is unrecognized gain in the other leg of the straddle.

### **Proposal**

The proposal would clarify that a taxpayer that holds an appreciated position in personal property cannot currently recognize loss or deduct expenses (including interest expenses) that are attributable to structured financial transactions that include a leg of the straddle. Thus, for example, if a taxpayer holds an appreciated position in actively traded stock and the taxpayer enters into a prepaid (or collateralized) forward contract to sell the stock, the taxpayer must capitalize all expenses associated with that forward contract.

In addition, the proposal would repeal the exception for stock in the definition of personal property. Thus, under the proposal, offsetting positions with respect to actively traded stock would generally constitute a straddle.

The proposal would be effective for straddles entered into on or after the date of enactment. No inference is intended with respect to the tax treatment of transactions entered into before such date.

## **DEFER INTEREST DEDUCTION AND ORIGINAL ISSUE DISCOUNT (OID) ON CERTAIN CONVERTIBLE DEBT**

### **Current Law**

If a financial instrument qualifies as a debt instrument, the issuer of the instrument may deduct stated interest as it economically accrues. In addition, if the instrument is issued at a discount, the issuer may deduct original issue discount (“OID”) as it economically accrues, even though the OID may not be paid until the instrument matures. The holder of a debt instrument includes stated interest under its regular method of accounting and OID as it economically accrues.

In the case of a debt instrument that is convertible into stock of the issuer or a related party, an issuer may deduct accrued interest and OID up until the time of the conversion, even if the accrued interest and OID is never paid because the instrument is converted.

### **Reasons for Change**

In many cases, the issuance of convertible debt instrument is viewed by market participants as a de facto issuance of equity. Allowing issuers to deduct accrued interest and OID is inconsistent with this market view.

### **Proposal**

The proposal would defer the deduction for accrued stated interest and OID on convertible debt until actual payment. Conversion into the stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)) would not be treated as a payment of accrued OID or interest. Payments in equity of the issuer or a related party, and payments in cash, the amount of which is determined by reference to the value of such equity, would also be disregarded for this purpose. For purposes of this proposal, convertible debt would include (i) debt exchangeable for the stock of the issuer or a related party, (ii) debt that provides for cash-settlement conversion features, or (iii) debt issued with warrants (or similar instruments) as part of an investment unit in which the debt component may be used to satisfy the exercise price for the warrant. This proposal would not apply to any debt that would be convertible solely because a fixed payment of principal or interest is payable, at the election of the holder, in an amount of the issuer’s or related party’s equity that has a value equal to the amount of the fixed payment. The proposal would not affect the treatment of holders.

The proposal would be effective generally for convertible debt issued on or after the date of first committee action.

## **Corporate Provisions**

### **CONFORM CONTROL TEST FOR TAX-FREE INCORPORATIONS, DISTRIBUTIONS, AND REORGANIZATIONS**

#### **Current Law**

For tax-free incorporations, distributions, and reorganizations, “control” is defined as the ownership of 80 percent of the voting stock and 80 percent of the number of shares of all other classes of stock of the corporation. In contrast, the necessary “ownership” for affiliation to insure that two corporations are permitted to file consolidated returns, tax-free liquidations, and qualified stock purchases is at least 80 percent of the total voting power of the corporation’s stock and at least 80 percent of the total value of the corporation’s stock. Prior to 1984, the test for affiliation was based on 80 percent of the voting stock and 80 percent of the number of shares of all other classes of stock of the corporation. In response to concerns that corporations were filing consolidated returns under circumstances in which a parent corporation’s interest in the issuing corporation accounted for less than 80 percent of the real equity value of such corporation, Congress amended the test. In 1986, the control test for tax-free liquidations and qualified stock purchases was harmonized with the test for affiliation.

#### **Reasons for Change**

The control test for tax-free incorporations, distributions, and reorganizations is easily manipulated by allocating voting power among the shares of a corporation. The absence of a value component allows corporations to retain control of a corporation but to “sell” a significant amount of the value of the corporation. While the ability to manipulate control has been present since the provision was enacted, there has been a proliferation of transactions that qualify under tax-free provisions but resemble sales because the value of the company has been stripped away from the voting power. Congress amended the test for affiliation to address similar concerns about manipulating the equity value of controlled corporations.

#### **Proposal**

The Administration proposes to conform the control test for tax-free incorporations, distributions, and reorganizations with the test for determining whether corporations satisfy the ownership test for affiliation. Thus, “control” would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of the corporation’s stock. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4).

This proposal is effective for transactions on or after the date of enactment.



## TAX ISSUANCE OF TRACKING STOCK

### Current Law

“Tracking stock” is an economic interest that is intended to relate to, and track the economic performance of, one or more separate assets of the issuer, and gives its holder a right to share in the earnings or value of less than all of the corporate issuer’s earnings or assets (a vertical slice of the issuer). Subsidiary tracking stock is in form stock of a parent corporation that is intended to relate to and track the economic performance of a subsidiary of the parent. The Internal Revenue Service has not issued any guidance regarding whether tracking stock is treated as stock of the issuer. Such determination is dependent upon the correlation to the underlying tracked assets.

### Reasons for Change

The use of tracking stock is clearly outside the contemplation of subchapter C and other sections of the Internal Revenue Code. As a result, a principal consequence of treating such a stock interest as stock of the issuer is the potential avoidance of these provisions. The use of tracking stock permits the circumvention of General Utilities repeal by allowing a corporation to “sell” an economic interest in a subsidiary without recognizing any gain. By treating tracking stock as stock of the issuer/parent, there is no gain or loss on the issuance of the tracking stock, the subsidiary may remain a member of the parent’s consolidated group, a distribution of the shares is tax-free to the shareholders and to the issuer, and the issuer can achieve separation from the tracked assets or subsidiary without satisfying the strict requirements for tax-free distributions.

### Proposal

The Administration proposes to provide that, upon issuance of “tracking stock” or a recapitalization of stock or securities into tracking stock, gain will be recognized in an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis. General principles of tax law would continue to apply to determine whether tracking stock is stock of the issuer or not stock of the issuer. In addition, the Secretary would have authority to treat tracking stock as nonstock (e.g., debt, a notional principal contract, etc.) or as stock of another entity as appropriate to prevent tax avoidance, and to provide for increased basis in the tracked assets as a result of gain recognized.

For this purpose, “tracking stock” would be defined as stock that relates to, and tracks the economic performance of, less than all of the assets of the issuing corporation (including the stock of a subsidiary), and either (1) the dividends are directly or indirectly determined by reference to the value or performance of the tracked entity or assets, or (2) the stock has liquidation rights directly or indirectly determined by reference to the tracked entity or assets. The issuance of tracking stock will not result in another class of the stock of the corporation becoming tracking stock if the dividend and liquidation rights of such other class are determined by reference to the corporation’s general assets, even though limited by the rights attributable to the tracking stock.

No inference regarding the tax treatment of the above-described stock under current law is intended by this proposal.

This proposal is effective for tracking stock issued on or after the date of enactment.

**REQUIRE CONSISTENT TREATMENT AND  
PROVIDE BASIS ALLOCATION RULES FOR TRANSFERS OF INTANGIBLES  
IN CERTAIN NONRECOGNITION TRANSACTIONS**

**Current Law**

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 the 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).

**Reasons for Change**

The inconsistency between the Service’s and the Claims Court’s positions has effectively resulted in taxpayers’ ability to choose taxable or tax-free treatment. In some cases, in order to achieve tax-free treatment, transferors take the position under Dupont that a transfer of less than all substantial rights is a transfer of property entitled to tax-free treatment. To the extent the intangible has basis, taxpayers generally do not allocate any basis to the partial interest in the intangible that is transferred, thereby allowing for the retention of basis by the transferor even though the value of the transferor’s interest in the intangible has been diminished. In other situations, taxpayers follow the Service’s position to create taxable income on the transfer to utilize expiring net operating losses or to increase basis in the transferred intangible.

**Proposal**

The transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor in the property would be treated 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 the transferee would be required. Further, the Administration proposes that, in the case of a transfer of less than all of the substantial rights, the transferor must allocate the basis of the intangible between the retained rights and the transferred rights based upon respective fair market values.

The proposal would not apply to transactions that are properly structured as licenses of intangibles. No inference is intended as to the treatment of these or similar transactions prior to the effective date.

This proposal is effective for transfers on or after the date of enactment.

## **MODIFY TAX TREATMENT OF DOWNSTREAM MERGERS**

### **Current Law**

In a downstream transaction, one corporation (a “target corporation”) that holds stock of another corporation (an “acquiring corporation”) transfers its assets (including acquiring corporation stock) to the acquiring corporation, and the shareholders of the target corporation receive stock of the acquiring corporation in exchange for their target corporation stock. Downstream transactions have been held to qualify as tax-free reorganizations.

### **Reasons for Change**

In substance, where the target corporation holds acquiring corporation stock, a downstream transaction has the same effect as a distribution by the target corporation of its acquiring corporation stock to its shareholders. This distribution generally would result in the recognition of gain by the target corporation. Also, where property is acquired in a reorganization, the acquiring corporation takes a carryover basis in the acquired property so that an appropriate amount of gain will be recognized when the property is eventually sold. However, where the property acquired is stock of the acquiring corporation, this treatment does not follow because the acquiring corporation does not recognize gain on any subsequent issuance of its own shares.

### **Proposal**

Under the proposal, where a target corporation does not satisfy the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to the acquiring corporation, and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor, the target corporation must recognize gain, but not loss, as if it distributed the acquiring corporation stock that it held immediately prior to the reorganization. As long as the other requirements for a reorganization are satisfied, nonrecognition treatment will continue to apply to other assets transferred by the target corporation and to the target corporation shareholders. The proposal also would apply to the acquisition of target corporation stock by the acquiring corporation in a transaction qualifying for nonrecognition treatment where the target corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date.

The proposal applies to transactions that occur on or after the date of enactment.

## **DENY DIVIDENDS-RECEIVED DEDUCTION FOR CERTAIN PREFERRED STOCK**

### **Current Law**

A corporate taxpayer is entitled to a deduction of 70 percent of the dividends it receives from a domestic corporation. The percentage deduction generally is increased to 80 percent if the taxpayer owns at least 20 percent (by vote and value) of the stock of the dividend-paying corporation, and to 100 percent for “qualifying dividends,” which generally are from members of the same affiliated group as the taxpayer.

The dividends-received deduction is disallowed if the taxpayer has held the stock for 45 days or less during the 90-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend. In the case of certain preferred stock, the dividends-received deduction is disallowed if the taxpayer has held the stock for 90 days or less during the 180-day period beginning on the date which is 90 days before the date on which such share becomes ex-dividend with respect to such dividend. The holding period generally does not include any period during which the taxpayer has a right or obligation to sell the stock, or is otherwise protected from the risk of loss otherwise inherent in the ownership of an equity interest. When an instrument is treated as stock for tax purposes, but provides for payment of a fixed amount on a specified maturity date and affords holders the rights of creditors to enforce such payment, no dividends-received deduction is allowed for distributions on the instrument. See Rev. Rul. 94-28.

The Taxpayer Relief Act of 1997 amended sections 351, 354, 355, 356, and 1036 to treat “nonqualified preferred stock” as boot in corporate transactions, subject to certain exceptions. Nonqualified preferred stock is defined in section 351(g) as preferred stock that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent, if (I) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (ii) the issuer or a related person is required to redeem or purchase the stock, (iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction rate stock). For this purpose, clauses (I), (ii), and (iii) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

### **Reasons for Change**

Taxpayers have taken advantage of the benefit of the dividends received deduction for payments on instruments that, while treated as stock for tax purposes, economically perform as debt instruments and have debt-like characteristics (e.g., enhanced likelihood of recovery of principal or of maintaining a dividend over the term of the instrument, or both). Current law denies the dividends

received deduction on similar instruments that are treated as stock for tax purposes where the taxpayer is protected from the risk of loss otherwise inherent in the ownership of an equity interest.

**Proposal**

Except in the case of “qualifying dividends”, the dividends-received deduction would be eliminated for dividends on nonqualified preferred stock (as defined in section 351(g)).

The proposal would apply to stock issued on or after the date of enactment.

## **Provisions Affecting Pass-through Entities**

### **MODIFY BASIS ADJUSTMENT RULES FOR PARTNERSHIP DISTRIBUTIONS**

The following coordinated proposals relate to gain recognition and basis adjustments upon the distribution of cash or property by a partnership.

1. *Provide mandatory basis adjustments with respect to partnership distributions*

#### **Current Law**

The basis of retained partnership property is not adjusted upon a distribution of other property to a partner unless an election under section 754 is in effect. Under section 734(b), if such an election is in effect, a partnership must increase the basis of retained partnership property by (1) the amount of gain recognized by a distributee partner and (2) the excess of the basis of the distributed property to the partnership over the basis of the property to the distributee partner. Conversely, where such an election is in effect, a partnership must decrease the basis of retained partnership property by (1) the amount of loss recognized by the distributee partner and (2) the excess of the basis of the distributed property to the distributee over the adjusted basis of the distributed property to the partnership.

#### **Reasons for Change**

The electivity of adjustments under section 734(b) provides substantial opportunities for taxpayer abuse. The primary abuse relates to the duplication of losses. Where a partner contributes loss property to a partnership and subsequently recognizes a loss upon receipt of cash in liquidation of that partner's interest in the partnership, the loss is attributable to the adjusted basis of the property that was contributed to the partnership. However, if a section 754 election has not been made so that the basis of the contributed property, which remains in the partnership, is not adjusted, the partnership will recognize the loss again when the property is sold. By avoiding a section 734(b) basis adjustment, the parties to the transaction essentially are able to create two losses where, without the use of the partnership, there would have been only one.

Apart from the opportunities for abuse, there are additional problems with the current operation of section 734(b). The objective of the section 734(b) basis adjustment is to conform the basis of the partnership's undistributed properties to the tax investment of the continuing partners; that is, the continuing partners' inside basis in partnership property prior to the distribution. Present law does not meet this objective because it adjusts basis by reference to the distributee partner's outside basis in its partnership interest.

#### **Proposal**

The Administration proposes that basis adjustments under section 734(b) be made mandatory. In addition, under the proposal, section 734(b) adjustments no longer would be measured by reference

to gain or loss recognized by the distributee partner or the difference between the basis of the distributed property and the distributee partner's basis in its partnership interest. Instead, the basis adjustment would be measured by reference to the difference between the basis of the distributed property and the amount by which the distributee partner's proportionate share of the adjusted basis of partnership property is reduced by the distribution. Special rules would apply with respect to tiered partnerships.

This proposal would apply to partnership distributions made on or after the date of enactment.

2. *Modify rules for allocation of basis adjustments for partnership distributions*

**Current Law**

The adjusted basis of property distributed to a partner other than in liquidation of the partner's interest is equal to the adjusted basis of the property to the partnership immediately before the distribution, except that the adjusted basis to the distributee partner may not exceed the adjusted basis of the partner's interest in the partnership reduced by the money distributed in the transaction. The adjusted basis of property distributed to a partner in liquidation of its partnership interest is equal to the basis of such partner's interest in the partnership reduced by the money distributed in the transaction. The adjusted basis of distributed property is allocated first to unrealized receivables and inventory items in an amount equal to the adjusted basis of each such property to the partnership, with any remaining basis being allocated among the other distributed property.

With respect to partnership basis adjustments under section 734(b), the partnership basis adjustment is divided between (1) capital assets and section 1231(b) property and (2) other assets. The portion of the increase or decrease in basis is allocated to the properties in a class in a manner which reduces the difference between the fair market value and the adjusted basis of partnership properties. With respect to basis adjustments relating to gain or loss recognized by a distributee partner, the basis adjustment is allocated only to capital assets or section 1231(b) property. Other adjustments relating to property distributions must be allocated to remaining partnership property of a character similar to that with respect to which the adjustment arose.

**Reasons for Change**

These basis allocation rules are intended to prevent partners from improperly shifting basis from capital assets or section 1231(b) property to ordinary income assets. While generally accomplishing this goal, the allocation rules still allow for a shifting of basis from non-depreciable assets to depreciable assets. Depreciation expenses are deducted against ordinary income, so such a shift in basis provides taxpayers with an opportunity to use the partnership rules to reduce ordinary income.

## **Proposal**

The proposal would modify the basis allocation rules for partnership liquidating distributions to include three asset classes. In a liquidating distribution, a partner would allocate basis to unrealized receivables, inventory items, and other ordinary income assets only to the extent of the adjusted basis of such assets to the partnership. The partner then would allocate basis to property of a character which is subject to the allowance for depreciation or amortization, again, only to the extent of the adjusted basis of such assets to the partnership. Residual allocations then would go to the remaining assets distributed from the partnership. A partner would recognize a long-term capital loss if it did not have assets to absorb the full basis in its partnership interest. Allocations of a basis increase (which only could occur in the third category) would be made first so as to reduce the difference between the fair market value and adjusted basis of each asset in the third category based upon the amount of such difference for each asset. Additional positive adjustments would be made in proportion to the fair market value of each asset in the third category. Negative adjustments (which could occur in any category) would be made first to third category assets so as to reduce the difference between the fair market value and adjusted basis of each such asset. Any remaining negative basis adjustment then would be allocated among third category assets in proportion to the adjusted basis of such assets. If a negative basis adjustment still remains after eliminating all asset basis in third category assets, basis adjustments then would be allocated among second category assets and finally first category assets using the same methodology.

The inside asset basis adjustments made pursuant to section 734(b) would be determined in the same manner. Accordingly, positive basis adjustments could be made only to third category assets. To the extent that a positive basis adjustment could not be made because the partnership did not possess any third category assets, the partnership would be treated as recognizing a long-term capital loss in the amount of the prevented adjustment. If a negative adjustment could not be made because the partnership holds no third category assets or has insufficient basis in such assets, the partnership would make a downward adjustment to the basis of the assets in the second and then first category assets.

Basis adjustments under section 743(b) would not be affected by this proposal.

This proposal would apply to partnership distributions made on or after the date of enactment.

### 3. *Modify rules for partial liquidations of a partnership interest*

## **Current Law**

A partner does not recognize gain upon a distribution from a partnership except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. A partner will not recognize a loss, except that upon a distribution in liquidation of a partner's interest where only cash, unrealized receivables, and inventory are distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the amount of cash and the basis of such other property



received. The basis of property (other than money) distributed to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership, unless such basis exceeds the partner's basis in its partnership interest. The basis of property distributed to a partner in liquidation of the partner's interest is equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

### **Reasons for Change**

The rules relating to partnership distributions provide for an inappropriate deferral of gain with respect to partnership distributions where all of a partner's basis in its partnership interest offsets cash that is used to redeem only a portion of the partner's interest. The rules also may allow a partner to obtain an inflated basis in partnership property distributed in partial liquidation of a partner's interest. In addition, the section 734(b) basis allocation rules described in the first proposal in this part do not operate properly in a system where a partner's entire basis in its partnership interest can be allocated to property distributed in partial redemption of the partner's interest.

### **Proposal**

The Administration proposes to treat a partial liquidation of a partner's interest in a partnership as a complete liquidation of that portion of the partner's interest. A partial liquidation would be a reduction in a partner's percentage share of capital, and the percentage that is reduced would be treated as a separate interest that is completely liquidated in the distribution. In the event of a partial liquidation, a distributee partner's basis in its partnership interest would be allocated between the redeemed interest and the partner's remaining interest, determined by reference to the percentage reduction in the partner's share of capital. Because the rules applicable to a complete liquidation would apply to the separate interest that is treated as being liquidated, it would be possible for a partner to recognize gain upon the receipt of cash in excess of the partner's basis in the separate interest, even if that partner's basis in its overall interest is greater than the amount of the cash distribution. In addition, section 734(b) and the basis allocation rules of section 732(c) would apply to the complete liquidation of the separate interest.

This proposal would apply to partnership distributions made on or after the date of enactment.

#### **4. Rules relating to distributions treated as sales or exchanges with respect to unrealized receivables and inventory items**

### **Current Law**

Under section 751(b), to the extent that a partner receives (1) unrealized receivables or substantially appreciated inventory in exchange for all or part of its interest in other partnership property, or (2) partnership property other than unrealized receivables or substantially appreciated inventory in exchange for all or part of its interest in partnership property that is unrealized receivables or substantially appreciated inventory, such transactions are, under regulations, treated as a sale or exchange of such property between the distributee and the partnership.

## **Reasons for Change**

Section 751(b) has been criticized for being overly complex. This provision was designed to prevent taxpayers from converting ordinary income to capital gains through partnership distributions where the distributee partner essentially transferred his share of ordinary income assets to the partnership in exchange for capital gain assets or vice versa. The proposals discussed above would prevent positive basis adjustments from being made to ordinary income assets, which would greatly reduce the ability to carry out the abuses that section 751(b) was intended to prevent.

## **Proposal**

The Administration proposes to repeal section 751(b).

This proposal would apply to partnership distributions made on or after the date of enactment.

5. *Require basis adjustments when a partnership distributes certain stock to a corporate partner*

## **Current Law**

The basis of property distributed to a partner in liquidation of the partner's interest is equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. No gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of a subsidiary corporation where the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) are satisfied and certain other requirements are met. The basis of property received by the distributee in such a corporate liquidation is the same as it was in the hands of the liquidated corporation.

## **Reasons for Change**

The rules regarding corporate liquidations provide taxpayers with the ability to negate the effect of a downward basis adjustment in a distribution by a partnership where the inside basis of partnership assets is higher than the basis of the partner's interest in the partnership. This can be accomplished by having the partnership contribute property to a corporation prior to a distribution to a corporate partner. Although the basis of the stock may be reduced as a result of the distribution, the stock basis is irrelevant if the corporation subsequently is liquidated by a corporate parent that owns 80 percent or more of the subsidiary.

## **Proposal**

The proposal would require that if stock of a corporation is distributed to a corporate partner that, after the distribution (and considering related transactions), owns stock satisfying the requirements of section 1504(a)(2), then the distributed corporation must adjust the basis of its assets by an amount equal to the amount by which the stock basis is adjusted as a result of the distribution.

The basis must be reduced using the same methodology as is used in section 732(c), determined as if the corporation's assets were being distributed.

This proposal would apply to partnership distributions made on or after the date of enactment.

## **MODIFY STRUCTURE OF BUSINESSES INDIRECTLY CONDUCTED BY REITS**

### **Current Law**

Real estate investment trusts (REITs) generally are restricted to making passive investments in real estate and certain securities. In furtherance of this purpose, REITs generally are limited under a 95 percent gross income test to receiving income that qualifies as rents from real property and, to a more limited degree, portfolio income.

The REIT provisions also contain a number of rules that limit a REIT's ownership of other corporations in order to prevent REITs from becoming active in the management and operations of companies that engage in activities that currently are prohibited activities for a REIT. One of these rules provides that a REIT may not own more than 10 percent of the outstanding voting securities of any issuer. Another rule provides that no single corporation can account for more than five percent of the total value of a REIT's assets.

### **Reasons for Change**

The Administration understands that REITs are conducting businesses through subsidiary corporations that, if operated directly, would generate nonqualifying income under the 95-percent gross income test. Through the use of multiple subsidiaries, up to 25 percent of the value of a REIT's assets can consist of subsidiaries that conduct these currently prohibited activities. Through the retention of non-voting preferred stock and debt, the REIT is able to retain most, if not all, of the income generated by the impermissible businesses and, due to the transmuting of operating income into interest paid to the REIT and other non-arm's length pricing arrangements, that income often is not subject to any corporate level tax.

Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

Currently, a REIT cannot derive more than a de minimis amount of income from the provision of services to REIT tenants unless such income would be excluded from unrelated business taxable income if received by certain tax-exempt entities. These services generally must be rendered by an independent contractor from whom the REIT does not derive or receive any income. The determination of what are permissible services for a REIT consumes substantial time and resources for both REITs and the Internal Revenue Service. In addition, the prohibition of a REIT performing, either directly or indirectly, non-customary services can put REITs at a competitive disadvantage in relation to others in the same market.

## **Proposal**

Under the proposal, the 10-percent vote test in section 856(c)(4)(B) would be changed to a “vote or value” test. This would prevent REITs from undertaking prohibited activities through preferred stock subsidiaries, as is the current practice.

The proposal also would provide an exception to the five-percent and 10-percent asset tests so that REITs could have “taxable REIT subsidiaries.” Under the proposal, there would be two types of taxable REIT subsidiaries, a “qualified independent contractor subsidiary” and a “qualified business subsidiary.” A qualified business subsidiary would be allowed to undertake non-tenant related activities that currently generate non-qualifying income for a REIT, such as third-party management and development. A qualified independent contractor subsidiary would be allowed to perform non-customary and other currently prohibited services with respect to REIT tenants as well as activities that could be performed by a qualified business subsidiary.

A number of constraints would be imposed on a taxable REIT subsidiary to ensure that the REIT could not, through a taxable REIT subsidiary, engage in substantial non-real estate activities, and also to ensure that the taxable REIT subsidiary pays a corporate level tax on its earnings. First, the value of all taxable REIT subsidiaries owned by a REIT could not represent more than 15 percent of the value of the REIT’s total assets, and within that 15-percent limitation, no more than five percent of the total value of a REIT’s assets could consist of qualified independent contractor subsidiaries. Second, a taxable REIT subsidiary would not be entitled to deduct any interest incurred on debt funded directly or indirectly by the REIT. Third, a 100-percent excise tax would be imposed on excess payments to ensure arm’s length (1) pricing for services provided to REIT tenants (*i.e.*, REIT tenants could not pay for services provided by the taxable REIT subsidiary through increased rental payments to the REIT) and (2) allocation of shared expenses between the REIT and the taxable REIT subsidiary. Fourth, there would be significant limits placed upon intercompany rentals between the REIT and a taxable REIT subsidiary. Finally, certain additional limitations may apply.

This proposal would be effective after the date of enactment. REITs would be allowed to combine and convert preferred stock subsidiaries into taxable REIT subsidiaries tax-free prior to a certain date. There would be a transition period to allow for conversion of preferred stock subsidiaries before the 10-percent vote or value test would become effective. Persons other than the REIT who hold stock in a preferred stock subsidiary would recognize gain to the extent that they received consideration other than REIT stock for their interest in the subsidiary.

## MODIFY TREATMENT OF CLOSELY HELD REITS

### Current Law

When originally enacted, the real estate investment trust (“REIT”) legislation was intended to provide a tax-favored vehicle through which small investors could invest in a professionally managed real estate portfolio. H.R. Rep. No. 2020, 86<sup>th</sup> Cong., 2d Sess., 2 (1960). REITs are intended to be widely held entities, and certain requirements of the REIT rules are designed to ensure this result. Among other requirements, in order for an entity to qualify for REIT status, the beneficial ownership of the entity must be held by 100 or more persons. In addition, a REIT cannot be closely held, which is determined by reference to the stock ownership requirement in the personal holding company rules. Under these rules, 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.

### Reasons for Change

A number of tax avoidance transactions involve the use of closely held REITs. In these transactions, in order to meet the 100 or more shareholder requirement, the REIT generally issues common stock and a separate class of non-voting preferred stock. The common stock, which reflects virtually all of the REIT’s economic value, is acquired by a single shareholder, and the preferred stock is acquired by 99 other “friendly” shareholders (generally, employees of the majority shareholder). The current-law closely held limitation does not disqualify the REITs that are utilizing this ownership structure because the majority shareholder of these REITs is not an individual.

The Administration believes that certain closely held structures may facilitate the use and development of corporate tax shelters in ways unintended by Congress. The Administration proposes modifying the closely held REIT requirements to address these potential abuses without frustrating the intended viability of REITs.

### Proposal

The proposal would impose as an additional requirement for REIT qualification that no person can own stock of a REIT possessing 50 percent or more of the total combined voting power of all classes of voting stock or 50 percent or more of the total value of all shares of all classes of stock. For purposes of determining a person’s stock ownership, rules similar to the attribution rules contained in section 856(d)(5) would apply. This proposal would not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

The proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action. An entity that elects REIT status for a taxable year beginning prior to the date of first committee action will be subject to this proposal if it does not have significant business assets or activities as of such date.

## **REPEAL TAX-FREE CONVERSIONS OF LARGE C CORPORATIONS TO S CORPORATIONS**

### **Current Law**

C corporations generally are subject to a two-tier tax. A corporation can avoid this two-tier tax by electing to be treated as an S corporation or by converting to a partnership. Converting to a partnership is a taxable event that generally requires the corporation to recognize any built-in gain on its assets and requires the shareholders of the corporation to recognize any built-in gain in their corporate stock. In contrast, the conversion of a C corporation to an S corporation generally is tax-free for both the corporation and its shareholders. Under section 1374, however, the S corporation must recognize the built-in gain on assets held at the time of conversion if the assets are sold within ten years.

A corporation generally also can avoid the two-tier tax if it can qualify as a regulated investment company (RIC) or a real estate investment trust (REIT) (by deducting dividends paid to its shareholders). The conversion of a C corporation to a RIC or REIT, however, is treated as if the corporation had sold all of its assets at their fair market value and immediately liquidated, thereby requiring the corporation to recognize any built-in gain in its assets at the time of the conversion. Notice 88-19, 1988-1 C.B. 486. The IRS, however, permits the corporation to avoid the immediate recognition of its built-in gain if the corporation elects to be subject to rules similar to section 1374.

### **Reasons for Change**

The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the tax treatment of the conversion of a C corporation to a partnership. Any appreciation in corporate assets that occurred during the time the corporation is a C corporation should be subject to the corporate-level tax.

### **Proposal**

The proposal would repeal section 1374 for large corporations. A C-to-S corporation conversion by a large corporation to S corporation status (whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation) would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Thus, the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

For this purpose, a large corporation is one with a value of more than \$5 million at the time of conversion. The value of the corporation would be the fair market value of all the stock of the corporation on the date of conversion.

The proposal would be effective for subchapter S elections that are first effective for a taxable year beginning after January 1, 2000. The proposal also would apply to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 31, 1999. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1999 or on January 1, 2000 without incurring the tax on conversion.

In addition, the Internal Revenue Service would revise Notice 88-19 to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal. As a result, the conversion of a large C corporation to a RIC or a REIT after the revisions would result in immediate recognition by the C corporation of the net built-in gain in its assets.



## **Tax Accounting**

### **DENY CHANGE IN METHOD TREATMENT TO TAX-FREE TRANSACTIONS**

#### **Current Law**

In general, a taxpayer that desires to change its method of accounting must obtain the consent of the Commissioner. In addition, in a nonrecognition transaction to which section 381 applies, an acquiring corporation must use the method of accounting used by the distributor or transferor corporation unless different methods of accounting were used by the parties to the transaction. If different methods of accounting were used, Treasury regulations generally provide that the acquiring corporation must adopt the principal method of accounting of the parties to the transaction. An acquiring corporation may use a method of accounting other than that required by section 381 and the regulations thereunder only if consent of the Commissioner is obtained.

Under current law, section 381 does not apply to the tax-free contribution to a corporation described in section 351 or the tax-free contribution to a partnership described in section 721. Consequently, taxpayers who transfer assets to a subsidiary or a partnership may avail themselves of a new method of accounting without obtaining the consent of the Commissioner.<sup>13</sup>

#### **Reasons for Change**

The Administration believes that it is inappropriate to allow taxpayers to circumvent the requirement to obtain consent of the Commissioner to change a method of accounting by merely contributing a business to a corporation or partnership.

#### **Proposal**

The proposal would expand the transactions to which the carryover of method of accounting rules in section 381 and the regulations thereunder apply to include section 351 and section 721 transactions.

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

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<sup>13</sup> Treasury regulations under section 1.1502-17 provide a general anti-abuse rule to prohibit a taxpayer from transferring an activity to another member with the principal purpose to avail the group of an accounting method that would be unavailable.

## **REPEAL INSTALLMENT METHOD FOR ACCRUAL BASIS TAXPAYERS**

### **Current Law**

Generally, an accrual method requires a taxpayer to recognize income when all events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general recognition principle by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. To the extent that an installment obligation is pledged as security for any indebtedness, the net proceeds of the secured indebtedness are treated as a payment on such obligation, thereby triggering the recognition of income.

A taxpayer generally is not allowed to use the installment method with respect to sales of its inventory. Exceptions to this rule are provided to farmers and dealers of timeshares and residential lots.

### **Reasons for Change**

The installment method is inconsistent with an accrual method of accounting and effectively allows an accrual method taxpayer to recognize income from certain property using the cash receipts and disbursements method. Consequently, the method fails to reflect the economic results of a taxpayer's business during the taxable year.

In addition, the pledging rules, which are designed to require the recognition of income when the taxpayer receives cash related to an installment obligation, are inadequate. For example, while a taxpayer who borrows money and pledges its installment obligation as security triggers the recognition of such installment obligation as if payment was received, a taxpayer who borrows money and gives a put right against its installment obligation may not trigger recognition of such installment obligation. Further, a taxpayer who, for example, pledges half of its installment obligation is able to obtain proceeds (from the loan and from actual subsequent payments on the obligation) equal to the full amount of the obligation while only recognizing half of the related income. Such a result occurs because 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.

### **Proposal**

The proposal would repeal the installment method of accounting for accrual method taxpayers (other than those taxpayers that benefit from dealer disposition exceptions under current law). The proposal also would eliminate the inadequacies in the pledging rules by clarifying that put rights or other similar arrangements will receive the same treatment as pledges and modifying the subsequent payment rule to take into account both loan proceeds and subsequent payments to the extent of the full amount of the installment obligation. The proposal generally would be effective for installment sales entered into on or after the date of enactment.

## **DENY DEDUCTION FOR PUNITIVE DAMAGES**

### **Current Law**

No deduction is allowed for a fine or similar penalty paid to a government for the violation of any law. If a taxpayer is convicted of a violation of the antitrust laws, or the taxpayer's plea of guilty or nolo contendere to such a violation is entered or accepted in a criminal proceeding, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or in settlement of a civil suit brought under section 4 of the Clayton Antitrust Act on account of such or any related antitrust violation.

Where neither of these two provisions is applicable, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on any trade or business, regardless of whether such damages are compensatory or punitive.

### **Reasons for Change**

The deductibility of punitive damage payments undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities.

### **Proposal**

No deduction would be allowed for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, such damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report such payments to the insured person and to the Internal Revenue Service. The proposal would apply to damages paid or incurred on or after the date of enactment.

## **APPLY UNIFORM CAPITALIZATION RULES TO TOLLERS**

### **Current Law**

Section 263A provides uniform rules for capitalization of certain expenses. Section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs of real or tangible personal property produced by a taxpayer or real or personal property described in section 1221(1) that is acquired by a taxpayer for resale. Costs attributable to producing or acquiring property generally must be capitalized by charging such costs to basis or, in the case of property which is inventory in the hands of the taxpayer, by including such costs in inventory.

In general, a toller performs certain manufacturing or processing operations on property owned by its customers either for a fee (known as a toll) or for a share of the production. Where the toller does not take title to the property, it may contend that it does not produce property or acquire property for resale. As a result, a toller may not capitalize certain direct and indirect costs attributable to some of its tolling activities.

### **Reasons for Change**

The uniform capitalization rules are intended to make the tax system more neutral by eliminating the differences in capitalization rules that created distortions between similarly situated taxpayers in the allocation of economic resources and in the manner in which certain economic activity was organized. The manufacturing and processing operations performed by a toller are identical to the manufacturing and processing operations performed by a producer subject to section 263A. However, a toller generally currently deducts the direct and indirect costs attributable to its tolling activities, while a producer must capitalize the direct and indirect costs attributable to its production activities. The disparate treatment between tollers and producers based on ownership of the property leads to the very distortions that the uniform capitalization rules were intended to eliminate.

### **Proposal**

The proposal would modify section 263A to require a toller to capitalize direct, and an allocable portion of indirect, costs allocable to property manufactured or processed under a contract manufacturing arrangement to the extent the toller would have been a producer subject to section 263A if it owned the property. For this purpose, a contract manufacturing arrangement is one in which the toller performs manufacturing or processing operations (including manufacturing, processing, finishing, assembling, or packaging) on property owned by its customers for a fee without the passage of title. Tollers would be required to capitalize direct and indirect costs (such as labor and overhead) allocable to property tolled. An exception would be provided for tollers that have average annual gross receipts for the prior three taxable years of less than \$1 million.

The proposal would be effective for taxable years beginning after the date of enactment. If a taxpayer is required to change its method of accounting to comply with the proposal, such change would be treated as initiated by the taxpayer with the consent of the Secretary of Treasury and any section 481 adjustment generally would be included in income ratably over a four-year period.

## **REPEAL LOWER-OF-COST-OR-MARKET INVENTORY ACCOUNTING METHOD**

## **Current Law**

Taxpayers required to maintain inventories are permitted to use a variety of methods to determine the cost of their ending inventories, including the last-in, first-out (“LIFO”) method, the first-in, first-out (“FIFO”) method, and the retail method. Taxpayers not using a LIFO method may determine the carrying values of their inventories by applying the lower-of-cost or market (“LCM”) method or by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other similar causes (the “subnormal goods” method).

## **Reasons for Change**

The allowance of write-downs under the LCM and subnormal goods methods is an inappropriate exception from the realization principle and is essentially a one-way mark-to-market method that understates taxable income.

## **Proposal**

The proposal would repeal the LCM and subnormal goods methods. Appropriate wash-sale rules also would be included. The proposal would be treated as a change in the method of accounting for inventories, and any resulting section 481(a) adjustment generally would be included in income ratably over a four-year period beginning with the year of change. These changes would not apply to taxpayers with average annual gross receipts over a three-year period of \$5 million or less, with appropriate aggregation rules.

The proposal would be effective for taxable years beginning after the date of enactment.

## **ELIMINATE THE INCOME RECOGNITION EXCEPTION FOR ACCRUAL METHOD SERVICE PROVIDERS**

### **Current Law**

An accrual method taxpayer generally must recognize income when all events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. In the event that a receivable arising in the ordinary course of the taxpayer's trade or business later becomes uncollectible, the accrual method taxpayer may deduct the account receivable as a business bad debt in the year in which it becomes wholly or partially worthless.

Accrual method service providers are provided a special exception to these general rules. Under this exception, a taxpayer using an accrual method with respect to amounts to be received for the performance of services is not required to accrue any portion of such amounts which (on the basis of experience) will not be collected (the "non-accrual experience method"). This exception applies as long as the taxpayer does not charge interest or penalties for failure to timely pay on such amounts.

### **Reasons for Change**

The Administration believes that the non-accrual experience method is an inappropriate method of accounting for tax purposes. The non-accrual experience method allows an accrual method service provider to reduce current taxable income by an estimate of its future bad debt losses. Thus, this method is the equivalent of establishing a bad debt reserve. The reserve method of accounting for bad debts repeatedly has been determined an unacceptable method of accounting for tax purposes because it results in a mismeasurement of economic income. Accordingly, it is inappropriate to continue to provide this tax benefit to service providers. In addition, because the tax benefit only applies to amounts to be received for the performance of services, it discriminates in favor of service providers and promotes controversy over whether a taxpayer's receivables represent amounts to be received for the performance of services or for the provision of goods.

### **Proposal**

The proposal would repeal the non-accrual experience method exception effective for taxable years beginning after the date of enactment. If a taxpayer is required to change its method of accounting to comply with the proposal, such change would be treated as initiated by the taxpayer with the consent of the Secretary of Treasury and any section 481 adjustment generally would be included in income ratably over a four-year period.

## **DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS**

### **Current Law**

No income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold investments that produce tax-exempt income. The determination of whether debt is used to acquire or hold tax-exempt investments differs depending on the holder of the instrument. For banks and a limited class of other financial institutions, debt generally is treated as financing all of the taxpayer's assets proportionately. For other corporations, and for individuals, however, a tracing rule is employed. Under this approach, deductions are disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt investments. Securities dealers are not included in the definition of "financial institution," and although they are subject to a case-law-based, pro-rata rule similar to the one that applies to other financial institutions, they benefit from a special exception to which financial institutions are not entitled. Securities dealers are allowed to trace borrowings to non-exempt purposes and to exclude the interest on those borrowings from the interest that is subject to the pro-rata disallowance rule. Thus, in general, the portion of a securities dealer's interest subject to possible disallowance under the pro-rata rule is generally much smaller than, for example, a bank's portion. Other financial intermediaries, such as finance companies, are also excluded from the definition of "financial institution," and therefore are subject only to the direct tracing rule, even though they operate similarly to banks.

### **Reasons for Change**

The current rules applicable to securities dealers and financial intermediaries other than banks permit them to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income, notwithstanding that they operate similarly to banks. The treatment of banks should be applicable to other taxpayers engaged in the business of financial intermediation, such as securities dealers. There is no reason to distinguish between banks and other financial intermediaries in this context. In both cases, it is difficult to trace funds within the institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings.

### **Proposal**

Under the proposal, the definition of "financial institution" under section 265(b) would be amended to include any person engaged in the active conduct of a banking, financing, or similar business, such as securities dealers and other financial intermediaries. Thus, a financial intermediary investing in tax-exempt obligations would be disallowed deductions for a portion of its interest expense equal to the portion of its total assets that is comprised of tax-exempt investments. The proposal would be effective for taxable years beginning after the date of enactment with respect to obligations acquired on or after the date of first committee action.

## **Cost Recovery**

### **PROVIDE CONSISTENT AMORTIZATION PERIODS FOR INTANGIBLES**

#### **Current Law**

Under current law, start-up and organizational expenditures are amortized at the election of the taxpayer over a period of not less than 60 months beginning with the month in which the trade or business begins pursuant to section 195 and section 248, respectively. Section 197 requires certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business or an activity for the production of income to be amortized over 15 years beginning with the month in which the intangible was acquired.

#### **Reasons for Change**

The Administration believes that to encourage the formation of new businesses, a fixed amount of start-up and organizational expenditures should be deductible in the year in which the trade or business begins. Further, the amortization period for the start-up and organizational expenditures that are not deductible in the year in which the trade or business begins should be consistent with the 15-year amortization period for section 197 intangibles.

#### **Proposal**

The proposal would allow a taxpayer to elect to deduct up to \$5,000 each of start-up or organizational expenditures in the taxable year in which the trade or business begins. However, each \$5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds \$50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for section 197 intangibles.

The proposal generally is effective for start-up and organizational expenditures incurred after the date of enactment.



## CLARIFY CLASS LIFE OF UTILITY GRADING COSTS

### **Current Law**

A taxpayer is allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or held for the production of income. For most tangible property placed in service after 1986, the amount of the depreciation deduction is determined under the modified accelerated recovery system (MACRS) using a statutorily prescribed depreciation method, recovery period, and placed in service convention. For some assets, the recovery period for the asset is provided in section 168. In other cases, the recovery period of an asset is determined by reference to its class life. The class life of an asset may be provided in section 168, or may be determined with regard to the list of class lives provided by the Treasury Department that was in effect on January 1, 1986.<sup>14</sup>

Electric and gas utility clearing and grading costs incurred to extend distribution lines and pipelines have not been assigned a class life. Consequently, electric and gas utility clearing and grading costs are classified as section 1245 real property with no class life. Such assets have a 7- year recovery period under MACRS.

### **Reason for Change**

The recovery period used for electric and gas utility clearing and grading costs does not reflect the economic useful life of such costs. Under pre-accelerated cost recovery system (ACRS) law, the IRS ruled that an average useful life of 84 years and 46 years would be accepted for the initial clearing and grading relating to electric transmission lines and electric distribution lines, respectively.<sup>15</sup> In addition, the electric utility transmission and distribution lines and the gas utility trunk pipelines benefitted by the clearing and grading costs have MACRS recovery periods of 20 years and 15 years, respectively.

### **Proposal**

The proposal would assign a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines. The proposal would classify these assets into the asset classes of the property to which the clearing and grading costs relate (generally, asset class 49.14 for electric utilities and asset class 49.24 for gas utilities, giving these assets a recovery period of 20 years and 15 years, respectively).

The proposal would be effective for electric and gas utility clearing and grading costs incurred after the date of enactment.

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<sup>14</sup> Rev. Proc. 87-56, 1987-2 C.B. 674

<sup>15</sup> Rev. Rul. 72-403, 1972-2 C.B. 102

## **Insurance Provisions**

### **REQUIRE RECAPTURE OF POLICYHOLDER SURPLUS ACCOUNTS**

#### **Current Law**

Between 1959 and 1983, stock life insurance companies deferred tax on a portion of their profits. These untaxed profits were added to a policyholders surplus account (“PSA”). In 1984, Congress precluded life insurance companies from continuing to defer tax on any future profits through PSAs. However, companies were permitted to continue their existing PSA accounts, and to pay tax on the previously untaxed profits only in certain circumstances.

Previously untaxed profits are taxed when and to the extent they are distributed or treated as being distributed to shareholders. Amounts are treated as being distributed from a PSA if a company ceases being an insurance company for a single taxable year, or if the company is not a life insurance company for two consecutive taxable years.

PSAs also are deemed to be distributed to the extent that the PSA exceeds the greatest of 15 percent of the company’s life insurance reserves, 25 percent of the amount by which the company’s current life insurance reserves exceed its life insurance reserves at the end of 1958, or 50 percent of the net amount of premiums and other consideration paid to the company.

#### **Reasons for Change**

Congress permitted stock life insurance companies to defer tax on a portion of their profits between 1959 and 1983 in part because of the perceived difficulty in “determining on an annual basis the true income of a life insurance company.” These rules were intended to allow insurance companies to deduct contingency reserves in case they needed funds in excess of their regular reserves to fulfill their legal obligations under their insurance policies. Previously untaxed profits were supposed to become subject to taxation when “they were no longer used to comply with the insurance company’s obligations to policyholders.” See Bankers Life and Casualty Co. v. United States, 142 F.3d 973 (7th Cir. 1998); Green v. United States, 42 Fed. Cl. 18 (1998).

There is no remaining justification for allowing stock life insurance companies to continue to defer tax on profits they earned between 1959 and 1983. Most pre-1984 policies have terminated, because pre-1984 policyholders have surrendered their pre-1984 contracts for cash, ceased paying premiums on those contracts, or died. Life insurance companies rarely, if ever, paid cash surrender values, death benefits or other benefits that exceeded the reserves they established for those pre-1984 contracts. To the extent pre-1984 contracts have not terminated, some companies that issued those contracts have reinsured them with other insurance companies, while either retaining their PSAs or distributing their PSAs to parent life insurance companies. Thus, PSAs typically have been separated from any remaining pre-1984 contracts. Companies generally take the position that these transactions do not trigger inclusion of PSAs into their gross income under current law.

## **Proposal**

Companies would be required to include in their gross income over ten years their PSA balances as of the beginning of the first taxable year starting after the date of enactment. In general, companies would be required to include one-tenth of this amount each year. To the extent that a company was required to include a portion of this PSA balance in income during this ten-year period due to a direct or indirect distribution, the company would include a prorata portion of its remaining PSA balance in income over the remainder of the 10-year period.

## **MODIFY RULES FOR CAPITALIZING POLICY ACQUISITION COSTS OF LIFE INSURANCE COMPANIES**

### **Current Law**

Since 1990, insurance companies issuing life insurance, annuity or noncancellable (including guaranteed renewable) health insurance policies have been required to capitalize a portion of their total policy acquisition costs. The amounts capitalized generally are equal to 2.05 percent of the net premiums on group life insurance contracts, 1.75 percent of the net premiums on annuity contracts, and 7.7 percent of the net premiums on individual life insurance, group and individual health insurance and certain other types of specified insurance contracts. No amounts are capitalized for pension plan, flight insurance, certain foreign branch contracts, and medical savings accounts. These percentages are applied to net premiums paid not only in the first contract year, when most policy acquisition costs are incurred for a policy, but also in subsequent contract years. In general, these capitalized amounts are amortized over 10 years (5 years for small companies). This special regime applies in lieu of normal tax accounting rules.

Under section 848(h), Treasury has the authority to modify these percentages and categories if the deferral of acquisition expenses for a type of contract under these provisions is substantially greater than the deferral of acquisition expenses that would have resulted if actual acquisition expenses (including indirect expenses) and the actual useful life for such type of contract had been used. If Treasury exercises this authority with respect to contracts in one of these statutory categories, the percentage of net premiums that is capitalized for the remaining contracts in that category must be adjusted so that Treasury's exercise of its authority does not decrease the amount of tax revenue received for any fiscal year.

Corporations generally are required to capitalize all of their costs of acquiring assets with useful lives that extend substantially beyond the taxable year, and to amortize those capitalized costs over the life of the asset. The purpose of these rules is to match income and deductions, thereby resulting in a more accurate calculation of income. See *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). These capitalization rules apply to financial intermediaries that compete against insurance companies.

### **Reasons for Change**

Current tax law fails to accurately reflect the economic income of life insurance companies for several reasons. First, life insurance companies generally capitalize only a fraction of their actual policy acquisition costs. In contrast, when preparing their financial statements using generally accepted accounting principles (GAAP), life companies generally capitalize their actual policy acquisition costs.

The life insurance industry currently capitalizes less than half of its actual policy acquisition costs, based on data reported annually by the life insurance companies to State insurance commissioners. Policy acquisition costs include commissions and other amounts that would be

required to be capitalized if normal capitalization rules applied, such as expense reimbursements to agents and amounts paid to agents' supervisors. Even if one assumed that policy acquisition expenses were limited to commissions, current tax law required capitalization of only a small portion of total commissions over the past five years (1993 through 1997):

Type of Insurance Contract	Percentage of Net Premiums Capitalized Under Current Law	Ratio of Commissions to Net Premiums, 1993-1997
Individual life insurance	7.70%	13.6%
Individual annuities	1.75%	6.1%
Group annuities	generally 0%	1.4%
Group health, including disability and long-term care	7.70%	7.6%
Individual health, including disability and long-term care	7.70%	18.9%
Group life insurance	2.05%	4.3%
Credit life insurance	generally 2.05%	49.0%
Credit health insurance	7.70%	53.3%

Current law also fails to accurately reflect the economic income of many life insurance companies, by imposing a 10-year straight-line amortization schedule for all lines of business, even though some types of policies (such as cash value life insurance) have substantially longer lives than other types of policies (such as certain types of guaranteed renewable health insurance or term life insurance).

Finally, current law fails to accurately reflect the economic income of companies that have lower than average or higher than average policy acquisition costs. Companies with low policy acquisition expenses are required to capitalize the same percentage of their net premiums as companies with high policy acquisition expenses. Companies that sell few new policies, and therefore incur low acquisition costs compared to their net premiums (which includes premiums paid on old policies) are required to capitalize the same percentage of their net premiums as companies with high total policy acquisition costs that are generated because their net premiums are generated disproportionately from newly issued policies.

**Proposal**

Insurance companies generally would be required to capitalize modified percentages of net premiums for five categories of insurance contracts. These modified percentages more closely reflect both the historic ratio of commissions to net premiums from 1993 through 1997 shown above and the typical useful lives for the policies included in each of these categories. As under current law,

capitalized amounts would be required to be amortized on a straight-line basis over a 10-year period (5 years for small companies).

As under current law, companies that issued pension contracts, flight insurance, qualified foreign branch contracts and medical savings accounts would not be required to capitalize any of their policy acquisition costs for these contracts. Companies that issued group or individual noncancellable health insurance also would continue to capitalize 7.7 percent of the net premiums for such contracts.

The proposal would modify current law in several respects. First, companies would be required to capitalize 2.05 percent of the net premiums on group or individual term life insurance. Second, companies would be required to capitalize 4.25 percent of the net premiums on non-pension annuity contracts for the first through fifth taxable year beginning after the date of enactment, and 5.15 percent of the net premiums on such contracts for the sixth and subsequent taxable years beginning after the date of enactment. Third, companies would be required to capitalize 10.50 percent of net premiums on cash value life insurance, credit life insurance, credit health insurance and any other specified insurance contracts (as defined under current law) for the first through fifth taxable years beginning after the date of enactment. This percentage of net premiums would increase from 10.50 percent to 12.85 percent for the sixth and subsequent taxable years beginning after the date of enactment.

Although these percentages are higher than the current capitalization percentages for certain lines of business, they are lower than the reported industry-wide ratio of commissions to net premiums for the lines of business in each category of contracts. To ensure that insurance companies are not required to capitalize more than would be appropriate under general tax principles, a special rule would apply. Under this rule, insurance companies that would capitalize a smaller amount of policy acquisition expenses for all their life insurance, annuity and noncancellable health insurance policies under general capitalization rules than by applying the statutory capitalization percentages to their net premiums on the types of contracts described above could elect to capitalize their actual policy acquisition expenses as a method of accounting. For this purpose, controlled insurance companies would be aggregated using the same rules that apply in determining whether a company qualifies for the small company 5-year amortization period.

## **INCREASE THE PRORATION PERCENTAGE FOR PROPERTY CASUALTY (P&C) INSURANCE COMPANIES**

### **Current Law**

Property casualty insurance companies generally are taxable on the sum of their underwriting income, investment income and other income. In computing their underwriting income, property casualty companies deduct reserves for losses and loss expenses incurred from their premiums earned. These loss reserves are funded in part with the property casualty company's investment income. The taxable investment income of property casualty companies generally does not include interest on tax-exempt bonds, the deductible portion of certain dividends received, or inside buildup on most insurance policies.

In 1986, Congress concluded that it was inappropriate for property casualty companies to fund fully deductible loss reserves with investment income that might be exempt from tax, such as interest on tax-exempt bonds or the deductible portion of certain dividends received. Thus, Congress reduced the reserve deductions of property casualty companies by 15 percent of the tax-exempt interest or the deductible portion of certain dividends received, for stock or obligations acquired after August 7, 1986.

In 1997, Congress concluded that it also was inappropriate for property casualty companies to fund fully deductible loss reserves with investment income that might be tax-exempt or tax-deferred under certain types of insurance contracts. Given this conclusion, Congress expanded the 15 percent proration rule to apply to the inside buildup on certain annuity, endowment, or life insurance contracts.

### **Reasons for Change**

The existing 15 percent proration rule still enables property casualty insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income. Other financial intermediaries, such as life insurance companies and banks, are subject to more stringent proration rules that substantially reduce or eliminate their ability to use tax-exempt or tax-deferred investments to fund currently deductible reserves or interest on loans.

### **Proposal**

The proration percentage would be increased from 15 percent to 25 percent, for taxable years beginning after the date of enactment with respect to investments acquired on or after the date of first committee action.

## **Exempt Organizations**

### **SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX**

#### **Current Law**

Nonprofit business leagues, chambers of commerce, trade associations, and professional sports leagues described in section 501(c)(6) generally are exempt from Federal income taxes. Such organizations generally are not subject to tax on membership dues and contributions they receive, and generally are not subject to tax on their investment income. However, section 501(c)(6) organizations are subject to tax on their unrelated business taxable income, which includes investment (and other) income derived from debt-financed property. In addition, the investment income of a section 501(c)(6) organization is subject to tax under section 527(f) to the extent that the organization makes expenditures during the taxable year in an attempt to influence the selection of an individual to any Federal, State, or local public office (which generally are referred to as “electioneering” expenditures).

In the case of tax-exempt social clubs, voluntary employees’ beneficiary associations (VEBAs), and certain other mutual benefit organizations, the unrelated business income tax (UBIT) generally applies under current law to all gross income --including investment income --other than certain “exempt function income,” such as membership receipts, income set aside to be used for charitable purposes specified in section 170(c)(4), and “rollover” gain on certain dispositions of property directly used by the organization in carrying out its exempt functions (sec. 512(a)(3)).

#### **Reasons for Change**

The current-law exclusion from the UBIT for certain investment income of a trade association allows the organization’s members to obtain an immediate deduction for dues or similar payments to the organization in excess of the amounts needed for current operations, while avoiding tax on a proportionate share of the earnings from investing such surplus amounts. If the trade association member instead had retained its proportionate share of the surplus and itself had invested that amount, the earnings thereon would have been taxed in the year received by the member. Although in some instances investment income earned tax-free by a trade association may be used to reduce member payments in later years, and hence reduce deductions claimed by members in such years, the member still has gained a benefit under current law through tax deferral. Thus, under current-law rules, trade association members may be able to claim current deductions for future expenses. Even assuming that dues and similar payments would be deductible by the member if made in a later year, to the extent that investment income is earned by the trade association in one year and spent in a later year, the current-law exclusion effectively provides the benefit of a deduction before the expenditure actually is made.



## **Proposal**

Trade associations and other organizations described in section 501(c)(6) would generally be subject to tax (at applicable corporate income tax rates) on their net investment income in excess of \$10,000. For this purpose, “net investment income” would be computed by adding all items of income described in paragraphs 1, 2, and 3 of section 512(b) (e.g., dividends, interest, royalties, and rents) and certain gains and losses from dispositions of property described in section 512(b)(5), and deducting all expenses directly connected with such items of income.

As under current-law section 512(a)(3), tax would not be imposed under the proposal to the extent that income is set aside to be used exclusively for a charitable purpose specified in section 170(c)(4). In addition, if an organization described in section 510(c)(6) sells property that is used directly in the performance of its exempt function, any gain from such sale is subject to tax under the proposal only to the extent that the association’s sales price of the old property exceeds the association’s cost of purchasing certain replacement property (see sec. 512(a)(3)(D)).

Under current-law section 6033(e)(1)(C), any lobbying and electioneering expenditures made by an organization described in section 501(c)(6) would be deemed to be made first out of the dues payments made by the members, which could result in a portion of dues payments being nondeductible under section 162(e) (or, as an alternative, the organization could elect to pay a proxy tax under sec. 6033(e)(2) on its lobbying and electioneering expenditures.)

The proposal would be effective for taxable years beginning on or after the date of enactment.

## **Estate and gift taxation**

### **RESTORE PHASE-OUT OF UNIFIED CREDIT FOR LARGE ESTATES**

#### **Current Law**

Prior to the Taxpayer Relief Act of 1997, the five-percent surtax added to the estate tax gradually phased out two benefits for estates with a value above \$10 million: the benefit of the estate tax brackets below 55 percent and the benefit of the unified credit. The Taxpayer Relief Act of 1997 amended the unified credit, increasing it gradually over the years 1998 through 2006 and effectively increasing the amount exempt from the estate and gift tax from \$600,000 (in 1997) to \$1,000,000 (in 2006). In attempting to amend the surtax provision to accommodate the scheduled increases to the unified credit, the Taxpayer Relief Act of 1997 inadvertently altered the operation of the surtax such that it currently phases out only the graduated estate tax brackets and does not phase out the benefit of the unified credit.

#### **Reasons for Change**

As evidenced by the legislative history of the Taxpayer Relief Act of 1997, there was no intention to change the application of the five percent surtax. The inadvertent reduction in the surtax gives an estate tax reduction to estates in excess of \$17,184,000.

#### **Proposal**

The proposal would increase the range of the five-percent surtax in order to restore its purpose of phasing out the benefit of the unified credit as well as the benefit of the graduated estate tax brackets. The phase-out range would increase as the unified credit continues to rise until 2006.

This proposal would be effective for decedents dying after the date of enactment.

## **REQUIRE CONSISTENT VALUATION FOR ESTATE AND INCOME TAX PURPOSES**

### **Current Law**

Under current law, the basis of property acquired from a decedent is the fair market value of the property on the date of death. In addition, property included in the gross estate of a decedent generally is valued at its fair market value on the date of death. However, there is no requirement that the determination of fair market value for estate tax purposes and the determination of fair market value for income tax purposes be consistent. The only current duty of consistency for estates concerns the duty of the beneficiary of a trust or estate to report for income tax purposes consistent with the Form K-1 information received from the trust or estate (section 6034A). The K-1, however, does not include basis information.

When a lifetime gift of property is made, the donee generally takes a carryover basis in the property. (Adjustments are made if gift tax is paid on the transfer, and the dual basis rules apply if the property is later sold at a loss.) However, there is no duty on the donor to notify the donee of the basis.

### **Reasons for Change**

Taxpayers should be required to take consistent positions when dealing with the Internal Revenue Service. The rationale for the step-up in basis at death is linked to the inclusion of the property in the estate of the decedent. Therefore, the reported estate tax value and the new basis should be the same. In the case of a gift in which the donee takes a carryover basis, the donor is in the best position to notify the donee of the basis. If such information is not passed on to the donee at the time of the gift, such information may be lost or unavailable by the time the property is sold by the donee.

### **Proposal**

The proposal would impose both a duty of consistency and a reporting requirement. First, a person taking a basis under section 1014 (property acquired from a decedent) would be required to use fair market value as reported on the estate tax return (if one is filed) as the basis for the property for income tax purposes. Second, a reporting requirement would be imposed on the estate (the executor) and the donor of a lifetime gift. The estate, by its executor, would be required to notify each heir of the fair market value on the date of death as reported on the estate tax return for any property distributed to such heir. This requirement would include property not passing under the will if such property is included in the gross estate. Donors of gifts (other than annual exclusion gifts) would be required to notify donees of the donor's basis in the property at the time of the transfer, as well as any payment of gift tax that would increase basis. A copy of these notices must be furnished to the IRS.

The proposal would be effective for transfers after the date of enactment in the case of lifetime gifts, and decedents dying after the date of enactment in the case of transfers at death.

## REQUIRE BASIS ALLOCATION FOR PART SALE/PART GIFT TRANSACTIONS

### Current Law

Under current law, where there is a transaction that is part gift, part sale, the treatment of the donor and the donee are as follows: The donee takes a basis equal to the greater of the amount paid by the donee or the donor's adjusted basis at the time of the transfer. (As in any gift transaction, however, there is a "dual basis," that is, if the property is later sold at a loss, the basis is limited to the fair market value at the time of the gift.) The treatment of the donor is not specified under current law. Thus donors presumably take the position that their basis is adjusted cost basis. This treatment by the donor and donee is not necessarily consistent.

### Reasons for Change

The donor and the donee in a part gift, part sale transaction should be required to take consistent positions so that no basis is lost or created by the transaction. Simple and rational rules are needed to allocate basis between the gift portion and the sale portion of the transaction.

### Proposal

This proposal would rationalize basis allocation in a part gift, part sale transaction by adopting the rule applied to bargain sales to charity under Code section 1011: the basis of part gift, part sale property would be allocated ratably between the gift portion and the sale portion based on the fair market value on the date of transfer and the consideration paid. For example, if the donor transferred property with a basis of \$40,000 and a fair market value of \$100,000 to child, and child paid consideration of \$50,000, child would take a basis of \$70,000 (\$50,000 for the consideration plus \$20,000 allocated portion of the donor's basis) and the donor would take a basis of \$20,000 (allocated portion of donor's basis on the date of transfer) for the purpose of reporting the gain on the sale part of the transaction. The donor would realize gain in the amount of \$30,000 (\$50,000 less \$20,000).<sup>16</sup> The dual basis rule would continue to apply if there is a loss transaction and the fair market value on the date of the gift was less than basis. For example, take the facts from above except the donor's basis just prior to the transfer was \$140,000. The donor would have a loss of \$20,000 (\$50,000 of consideration less allocated basis of \$70,000). Child's unadjusted basis would be \$120,000, but if child sold the property at a loss, basis would be limited to \$100,000. As under present law, if the amount realized from the sale by child is between the basis for loss and the basis for gain, no gain or loss is realized.

This proposal would be effective for transactions entered into after the date of enactment.

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<sup>16</sup> All of the examples assume that no gift tax is paid on the gift.

## **CONFORM TREATMENT OF SURVIVING SPOUSES IN COMMUNITY PROPERTY STATES**

### **Current Law**

Subject to limited exceptions, property acquired from a decedent at death is assigned a new basis equal to the fair market value of the property at the date of the decedent's death (a "stepped-up basis"). In a common law (non-community property) State, property jointly owned by husband and wife at the time one of them dies is treated as owned one-half by the deceased spouse and one-half by the surviving spouse. The surviving spouse receives a stepped-up basis in the deceased spouse's half. The half already owned by the surviving spouse, however, is not eligible for a step up in basis. Similarly, in a community property State, each spouse is treated as owning one-half of the community property. Under section 1014(b)(6), however, the surviving spouse is entitled to a stepped-up basis in the portion of the community property owned by the surviving spouse, as well as the portion owned by the decedent.

At present, there are 9 community property States and at least one other State with an elective community property regime.

### **Reasons for Change**

When enacted in 1948, the stepped-up basis for community property was premised on the fact that "the usual case was that practically all the wealth of the married couple was the property of the husband." S. Rep. 1013, 80th Cong., 2d Sess. (1948), 1948-1 C.B. 285, 304. Societal changes and changes to the estate tax treatment of jointly held property in 1981 have undermined the premises on which section 1014(b)(6) was based. Consequently, surviving spouses in community property States now enjoy an unwarranted tax advantage over those in common law States.

### **Proposal**

The proposal would eliminate the stepped-up basis in the part of the community property owned by the surviving spouse prior to the deceased spouse's death. The half of the community property owned by the deceased spouse would continue to be entitled to a stepped-up basis.

This proposal would be effective for decedents dying after the date of enactment.

## **INCLUDE QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST ASSETS IN SURVIVING SPOUSE'S ESTATE**

### **Current Law**

A marital deduction is allowed for qualified terminable interest property (QTIP) passing to a qualifying trust for a spouse either by gift or by bequest. Under section 2044, the value of the recipient spouse's estate includes the value of any such property in which the decedent had a qualifying income interest for life and a deduction was allowed under the gift or estate tax.

### **Reasons for Change**

The marital deduction is intended to defer the estate tax until the death of the surviving spouse, not to excuse payment of the tax permanently. In some cases, taxpayers have attempted to whipsaw the government by claiming the marital deduction for QTIP property in the first estate and then, after the statute of limitations for assessing tax on the first estate has elapsed, arguing against inclusion under section 2044 in the second estate due to some technical flaw in the QTIP eligibility or election in the first estate. Since the surviving spouse has benefitted from the deferral of estate tax due to the marital deduction taken in the first estate, the property should be includable in the surviving spouse's estate even if the surviving spouse later discovers that the marital trust did not in fact qualify for the QTIP election in the first estate.

### **Proposal**

The proposal would amend section 2044 to provide that, if a marital deduction is allowed with respect to QTIP property under section 2523(f) or 2056(b)(7), inclusion is required in the beneficiary spouse's estate under section 2044.

The proposal would be effective for decedents (i.e., surviving spouses) dying after the date of enactment.

## **ELIMINATE NON-BUSINESS VALUATION DISCOUNTS**

### **Current Law**

Under current law, taxpayers making gratuitous transfers of fractional interests in entities routinely claim discounts on the valuation of such interests. The concept of valuation discounts originated in the context of active businesses, where it has long been accepted that a willing buyer would not pay a willing seller a proportionate share of the value of the entire business when purchasing a minority interest in a non-publicly traded business.

Without legislation in this area, tax planners have carried this concept over into the family estate planning area, where a now common planning technique is to contribute marketable assets to a family limited partnership or limited liability company and make gifts of minority interests in the entity to other family members. Taxpayers then claim large discounts on the valuation of these gifts.

### **Reasons for Change**

The use of family limited partnerships and similar devices is eroding the transfer tax base. Taxpayers take the position that they can make value disappear by making contributions of marketable assets to an entity, and then making gifts of interests in such entity to family members. This disappearing value is illusory, because family members are not minority interest holders in any meaningful sense. Moreover, it is implausible that the donor would intentionally take an action (contribution of the property to an entity) if the donor really believed that such action would cause the family's wealth to decline substantially.

### **Proposal**

The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds non-business assets (such as cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (i.e., not subject to the limits on valuation discounts). No inference is intended as to whether these discounts are allowable under current law.

This proposal would be effective for transfers made after the date of enactment.

## ELIMINATE GIFT TAX EXEMPTION FOR PERSONAL RESIDENCE TRUSTS

### Current Law

Under section 2702, if an interest is retained by a grantor in a trust when other interests are transferred to family members, the retained interest is valued at zero for gift tax purposes unless it takes the form of an annuity (a GRAT), a unitrust (a GRUT), or a remainder interest after a GRAT or a GRUT. However, section 2702(a)(3)(A)(ii) provides an exception for a trust “all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust.” As written, this exemption completely removes personal residence trusts from the purview of section 2702.

### Reasons for Change

Because the exemption under section 2702 completely removes personal residence trusts from section 2702, such trusts receive more favorable gift tax treatment than that given to the statutorily authorized GRATs and GRUTs. Specifically, when valuing the gift made to the remainderman in a personal residence trust, the value of any reversionary interest in the grantor can be taken into account, and such value reduces the amount of the taxable gift. In contrast, even if the grantor has a reversionary interest in a GRAT or a GRUT, section 2702 prohibits the actuarial value of that interest from being taken into account in valuing the gift.

Furthermore, by requiring a grantor’s retained interest in a trust to take the form of an annuity or a unitrust, section 2702 was attempting to make sure that the grantor would actually receive the interest valued by the actuarial tables. This requirement was designed to prohibit the pre-2702 grantor retained *income* trusts (GRITs), in which the actuarial tables were used to value the grantor’s retained income interest even when the projected income was zero or minimal.

Experience has shown that the use value of the residence retained by the grantor is a poor substitute for an annuity or unitrust interest. In the personal residence trust, the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence. Therefore, the true rental value of the house should be less than fair market rent. In these circumstances, the actuarial tables overstate the value of the grantor’s retained interest in the house.

### Proposal

The proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantor’s retained interest would be valued at zero for gift tax purposes.

The proposal would be effective for transfers in trust after the date of enactment.



## **International**

### **EXPAND SECTION 864(c)(4)(B) TO INTEREST AND DIVIDEND EQUIVALENTS**

#### **Current Law**

Under sections 871(b) and 882, a foreign person is subject to taxation in the United States on a net income basis with respect to income that is effectively connected with a U.S. trade or business (ECI). A foreign person may also be subject to a 30 percent gross basis tax with respect to U.S.-source fixed or determinable annual or periodical gains, profits or income (FDAP) and certain capital gains that do not constitute ECI. A foreign person generally is not subject to U.S. tax on foreign-source income that does not constitute ECI.

Section 864(c) provides rules for determining whether income is ECI. The test for determining whether income is effectively connected with a U.S. trade or business differs depending on whether the income at issue is U.S.-source or foreign source. U.S.-source FDAP is ECI if it is derived from assets used in or held for use in the active conduct of a trade or business in the United States or from business activities conducted in the United States. All U.S.-source income other than FDAP automatically constitutes ECI.

Foreign-source income may constitute ECI only if it consists of certain enumerated types of income -- rents, royalties, dividends, interest, gains from the sale of inventory property, and insurance income -- and certain other conditions are met. In the case of dividends and interest, the income must be attributable to an office of the foreign person in the United States and the foreign person must derive the income in the active conduct of a banking, financing or similar business within the United States or be a foreign corporation engaged in business in the United States whose principal business is trading in stocks or securities for its own account.

Court decisions have held that the source of certain types of payments -- such as acceptance and confirmation letter of credit and loan guarantee fees -- should be determined by analogy to the rules for determining the source of interest income because the recipient is being compensated for substituting its credit for the credit of the person whose obligations are being guaranteed. As a result, the payment is foreign source if the person being guaranteed is a foreign person.

#### **Reasons for Change**

The rules for determining whether income that is sourced by analogy to interest and dividends is ECI should be the same as the rules for determining whether interest and dividends themselves would be ECI. The current rules create arbitrary distinctions between economically similar transactions that are equally related to the U.S. trade or business. Guarantees of foreign risk by a U.S. trade or business are closely analogous to an extension of credit through the material activities of the U.S. office or fixed place of business, but currently are treated differently. For example, under current law, a short-term loan to a foreign customer by the U.S. branch of a foreign corporation would

generate ECI, while the guarantee of a note which the foreign customer could then negotiate in order to raise cash would not.

### **Proposal**

The proposal would expand the categories of foreign-source income that could constitute ECI under section 864(c)(4)(B)(ii) to include interest equivalents and dividend equivalents. Such income would constitute ECI in the same circumstances as dividends or interest. For these purposes, the term “interest equivalent” would include letter of credit fees, guarantee fees and loan commitment fees (whether or not the loan is actually made).

The proposal does not affect the determination of whether such interest or dividend equivalents would be U.S.-source or foreign-source.

The proposal would be effective for taxable years beginning after date of enactment.

## **RECAPTURE OVERALL FOREIGN LOSSES WHEN CFC STOCK IS DISPOSED**

### **Current Law**

Section 904(f) establishes a regime for the treatment of overall foreign losses (OFLs). Under section 904(f)(3), if a taxpayer disposes of trade or business property used predominantly outside the United States, any gain arising from such disposition may be recharacterized as U.S. source income up to the lesser of the amount of the gain, or the amount of outstanding OFLs (without being subject to the 50 percent limitation on recapture in section 904(f)(1)). However, for purposes of section 904(f), stock is not treated as trade or business property for purposes of the recapture rules. If, therefore, a domestic corporation disposes of stock in a subsidiary, gain on such disposition is not subject to the section 904(f)(3) disposition rules.

### **Reasons for Change**

A U.S. corporation may choose to conduct its operations through a subsidiary controlled foreign corporation (CFC), rather than directly through ownership of foreign assets. Under the interest allocation rules of section 864(e) and §1.861-9T, interest is allocated to foreign sources based not only on the value of foreign assets, but also on the tax book value of the stock of any CFCs owned by the U.S. corporation. Ownership of stock in a foreign subsidiary can, therefore, lead to, or increase, an overall foreign loss by increasing interest deductions allocated against foreign income. If, however, following the creation of this OFL the CFC is, for example, spun off to unaffiliated shareholders, OFLs which relate to ownership of the CFC may never be recaptured. The proposal corrects this asymmetry.

### **Proposal**

For purposes of section 904(f), the property subject to the recapture rules upon disposition under section 904(f)(3) would include stock in a controlled foreign corporation. The proposal would be effective from date of enactment.

## AMEND 80/20 COMPANY RULES

### **Current Law**

A portion of interest and dividends paid by a domestic corporation is effectively exempt from U.S. withholding tax provided the corporation qualifies as a so-called 80/20 corporation. In general, interest or dividends paid by a domestic corporation will be treated as interest or dividends from an 80/20 corporation if at least 80 percent of the gross income of the corporation for the testing period is foreign source income attributable to the active conduct of a foreign trade or business (or the foreign business of a subsidiary). The testing period is the three year period preceding the year of the dividend.

### **Reasons for Change**

The testing period relevant for determining 80/20 company status is subject to manipulation such that certain foreign persons may utilize the 80/20 company rules in order to improperly avoid U.S. withholding tax with respect to certain distributions attributable to U.S. source earnings of a subsidiary.

### **Proposal**

The proposal would prevent taxpayers from manipulating the testing period in order to avoid U.S. withholding tax on certain distributions attributable to U.S. source earnings by applying the 80/20 test on a group-wide basis. For this purpose, the group would include the U.S. corporation making the payment, as well as any subsidiary in which that corporation owns, directly or indirectly, at least 50 percent of the stock.

The proposal would apply to interest or dividends paid or accrued more than 30 days after the date of enactment.

**MODIFY FOREIGN OFFICE MATERIAL PARTICIPATION EXCEPTION  
APPLICABLE TO INVENTORY SALES ATTRIBUTABLE  
TO NONRESIDENT'S U.S. OFFICE**

**Current Law**

Foreign corporations and nonresident alien individuals engaged in a trade or business within the United States are taxable on a net basis on their taxable income that is effectively connected with the conduct of a U.S. trade or business. The determination of whether income is effectively connected depends in part on whether the income is from sources within the United States or without the United States. In general, if a nonresident maintains an office or other fixed place of business in the United States, income from any sale of personal property (including inventory property) attributable to such place of business is sourced in the United States. As a result, such income is treated as effectively connected with the conduct of the U.S. trade or business and is subject to net basis taxation.

However, this general rule does not apply to any sale of inventory property that is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participates in the sale. Under these circumstances, the source of the income depends on where title to the inventory property passes. As a result, if title passes outside the United States, the income is not treated as effectively connected with the conduct of a U.S. trade or business, and is not subject to tax by the United States.

**Reasons for Change**

As a result of this material participation exemption, the sale of inventory property for use, disposition, or consumption outside the United States may not be subject to United States taxation even though the sale is attributable to an office or other fixed place of business in the United States. Moreover, the sale may not be subject to taxation in any other jurisdiction. The United States should not cede its jurisdiction to tax sales of inventory property that are attributable to an office or other fixed place of business in the United States unless the sale is actually taxed by a foreign country at some minimal level.

**Proposal**

The proposal would provide that the source rule exception for sales of inventory property for use, disposition, or consumption outside the United States in which the nonresident's foreign office or other fixed place of business materially participates shall apply only if an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income. The proposal would be effective for transactions occurring on or after the date of enactment.

## **STOP ABUSE OF CONTROLLED FOREIGN CORPORATION (CFC) EXCEPTION TO OWNERSHIP REQUIREMENTS OF SECTION 883**

### **Current Law**

Section 887 of the Code imposes a 4 percent tax on the United States source gross transportation income of nonresident alien individuals and foreign corporations, if the income is not effectively connected with a United States trade or business. Sections 871 and 882 impose tax on income that is effectively connected with a United States trade or business at the graduated rates that apply to U.S. persons. However, sections 872(b)(1) and (2) and section 883 provide that the gross income of nonresident alien individuals and foreign corporations is not to include income from the international operation of ships or aircraft derived by such foreign persons resident in a foreign country that grants an equivalent exemption to U.S. persons, either by agreement or under domestic law. To prevent abusive use of “exemption-country” corporations by residents of non-exemption countries, section 883(c) denies the exclusion from gross income to corporations that are 50 percent or more owned by individuals who are not residents of an exemption country. That exception to the exclusion does not apply, however, to a foreign corporation that is a controlled foreign corporation (a “CFC”). Section 883(c)(2). That is, if a foreign corporation is a CFC, there are no (further) restrictions placed on its ownership with respect to eligibility for the exclusion. Thus, a CFC formed in an exemption country may exclude its international shipping income from gross income, regardless of the nationality of its ultimate owners.

In general, a CFC is a foreign corporation that is more than 50 percent owned by U.S. persons that each own 10 percent or more of the foreign corporation. A partnership organized in the U.S. or under U.S. law is a U.S. person for these purposes, regardless of the nationality of its owners. Thus, a foreign corporation that is wholly owned by non-resident aliens through a U.S. partnership is a CFC. Such a corporation is thereby eligible for the exemption regardless of whether its ultimate individual owners are residents of exemption countries.

### **Reasons for Change**

Foreign persons from non-exemption countries are forming U.S. partnerships and then having the partnerships form corporations resident in exemption countries. The foreign corporations are CFCs because they are wholly owned by U.S. persons (the U.S. partnerships), and therefore the anti-abuse rule of section 883(c) requiring exemption country ownership does not apply. In this manner, the foreign persons achieve exemption of their foreign corporations’ international ship and aircraft transportation income from the 4 percent gross tax under section 887 and from the tax on effectively connected income. Thus, interposing the U.S. partnership eliminates an otherwise applicable U.S. tax by circumventing an anti-abuse rule. Besides allowing foreign persons to avoid U.S. tax, the provisions provide a disincentive for countries to enter into reciprocal exemption agreements with the United States, as the exemption from United States tax is already easily and generally available to their residents.

## **Proposal**

The Code would be amended to provide that the anti-abuse rule of Code section 883(c)(2) requiring at least 50 percent ownership by foreign individuals who are residents of an exemption country shall apply unless more than 50 percent of the stock of the CFC is owned (within the meaning of Code section 958(b)) by United States shareholders that are individuals or corporations required to include in gross income the subpart F income of the CFC . That narrows the exception and ensures the exception is available only when U.S. persons subject to U.S. tax own the CFC. That should prevent the abuse and, in addition, encourage countries to negotiate reciprocal exemptions with the United States. It is intended that no inference be drawn from this proposal regarding the authority of the Secretary to achieve the same result through the issuance of regulations. The provision would be effective for taxable years beginning after the date of enactment.

## **REPLACE SALES-SOURCE RULES WITH ACTIVITY-BASED RULES**

### **Current Law**

The foreign tax credit generally reduces U.S. tax on foreign source income, but does not reduce U.S. tax on U.S. source income. Where products are manufactured in the United States and sold abroad, Treasury regulations provide that 50 percent of such income generally is treated as earned in production activities, and sourced on the basis of the location of assets held or used to produce income which is derived from the export sales. The remaining 50 percent of the income is treated as earned in sales activities and sourced based on where title to the inventory transfers. Thus, if a U.S. manufacturer sells inventory abroad, half of the income generally is treated as derived from domestic sources, and half of the income generally is treated as derived from foreign sources. However, the taxpayer may use a more favorable method if it can establish to the satisfaction of the IRS that more than half of its economic activity occurred in a foreign country. Different rules apply to the export of natural resources.

### **Reasons for Change**

The existing 50/50 rule provides a benefit for U.S. exporters that also operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States. Different categories of exporters should be treated equally.

In addition, the United States has established an income tax treaty program that encompasses approximately 50 countries during the 70 years since the 50/50 rule of current law has been in place. These treaties protect export sales income from local taxation in the country where the goods are sold. Now that export sales income generally is not subject to foreign tax, it is not appropriate to maintain the existing allowance of foreign tax credits against that income.

### **Proposal**

Under the proposal, the 50/50 rule would be replaced by a rule requiring that the allocation between production activities and sales activities be based on actual economic activity.

The proposal would not change the tax rules that apply to the export of natural resources.

The proposal would be effective for taxable years beginning after the date of enactment.



## **MODIFY RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME**

### **Current Law**

The United States taxes U.S. persons on their worldwide income. A credit against U.S. tax on foreign income is allowed for foreign income taxes paid by the U.S. person. In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations upon payment of an actual or deemed dividend by the subsidiary (the “deemed paid” or “indirect” foreign tax credit).

To be a creditable income tax, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of the label the foreign government attaches to it. Under regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive (directly or indirectly) a specific economic benefit from the levying country are referred to as “dual capacity” taxpayers and may not claim a credit for that portion of the foreign levy paid as compensation for the specific economic benefit received. Under a regulatory safe-harbor test, if a country has a generally imposed income tax, the dual-capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (to the extent the levy otherwise constitutes an income tax or an “in lieu of” tax); the balance is treated as compensation for the specific economic benefit. If there is no generally imposed income tax, the regulation treats as a creditable tax that portion of the payment that does not exceed the applicable U.S. tax rate applied to net income. A foreign tax is treated as “generally imposed” even if it applies only to persons who are not residents or nationals of that country.

There is no separate section 904 foreign tax credit “basket” for oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on FOGEI is limited in any year to the applicable U.S. tax on that income.

### **Reasons for Change**

The purpose of the foreign tax credit is to avoid double taxation of income by both the United States and a foreign jurisdiction. When a payment to a foreign government is made as compensation for a specific economic benefit, there is no incidence of double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

### **Proposal**

The proposal would treat payments by a dual-capacity taxpayer to a foreign country that would otherwise qualify as income taxes or “in lieu of” taxes as taxes only if there is a “generally applicable income tax” in that country. For this purpose, a generally applicable income tax is an income tax (or

a series of income taxes) that applies to trade or business income from sources in that country, so long as the levy has substantial application both to non-dual-capacity taxpayers and to persons who are citizens or residents of that country. The proposal thus would replace that part of the regulatory safe harbor that treats a foreign levy as a tax up to the amount of the U.S. tax where the foreign country has no generally applicable income tax. The proposal generally would retain the rule of current law where the foreign country does generally impose an income tax. In that case, credits would be allowed up to the level of taxation that would be imposed under that general tax, so long as the tax satisfies the statutory definition of a “generally applicable income tax.” The proposal also would convert the special foreign tax credit limitation rules of current-law section 907 into a new foreign tax credit basket within section 904 for foreign oil and gas income.

The proposal would be effective for taxable years beginning after the date of enactment. The proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

## **Pensions**

### **INCREASE ELECTIVE WITHHOLDING RATE FOR NONPERIODIC DISTRIBUTIONS FROM DEFERRED COMPENSATION PLANS**

#### **Current Law**

Under current law, section 3405 provides that the payor of any “designated distribution” that is a nonperiodic distribution must withhold ten percent of the amount of the distribution unless the individual to whom the distribution is to be made elects not to have any amount withheld from the distribution. The term “designated distribution” means any distribution from an employer deferred compensation plan (including a qualified plan), an individual retirement account or annuity, or a commercial annuity. The term does not include any amount otherwise treated as wages, the portion of any distribution which it is reasonable to believe is not includable in gross income, any amount subject to withholding of tax on nonresident aliens and foreign corporations, and certain dividends paid with respect to employee stock ownership plans. This ten-percent elective withholding under section 3405 does not apply in the case of “eligible rollover distributions” from qualified plans (which are subject to 20-percent mandatory withholding unless the participant elects a “direct rollover”).

#### **Reasons for Change**

The ten-percent withholding rate for nonperiodic distributions is generally too low for taxpayers who wish to have the proper amount withheld from such distributions. Because this withholding is elective, the withholding rate should more closely approximate the amount of tax liability that the taxpayer will have with respect to the distribution.

#### **Proposal**

The proposal would increase the 10 percent elective withholding rate on nonperiodic distributions (such as lump sum distributions) from pensions, IRAs and annuities to 15 percent. Thus, a nonperiodic distribution from a deferred compensation plan would be subject to 15-percent federal income tax withholding unless the recipient of the distribution elected not to have withholding apply.

The proposal would be effective for distributions made after 1999.

## **INCREASE SECTION 4973 EXCISE TAX FOR EXCESS IRA CONTRIBUTIONS**

### **Current Law**

A taxpayer's regular contributions to all of his or her IRAs for a year are limited to the lesser of \$2,000 or the taxpayer's compensation for that year. A special rule for married taxpayers permits one spouse to treat the other spouse's compensation as his or her own for purposes of the limit on regular contributions. Any contribution in excess of the contribution limit is subject to the six-percent excise tax under section 4973 unless it is distributed to the taxpayer (with allocable net income) under section 408(d)(4) by the federal income tax return due date (with extensions) for the year of the contribution.

"Qualified distributions" from a Roth IRA are not includable in gross income. A qualified distribution is a distribution that is both (1) made after the end of the five-taxable-year period that begins with the first taxable year for which an individual first makes any regular or conversion contribution to a Roth IRA and (2) made at any time after the Roth IRA owner has reached age 59-1/2, made to a beneficiary (or to the Roth IRA owner's estate) after the Roth IRA owner's death, attributable to the Roth IRA owner's being disabled, or made for certain first-time home purchases. The statute does not preclude amounts attributable to excess contributions (other than excess contributions and net allocable income distributed under section 408(d)(4)) from constituting qualified distributions if they satisfy these requirements.

### **Reasons for Change**

The potential to secure qualified-distribution treatment for amounts attributable to excess Roth IRA contributions may encourage taxpayers to make regular Roth IRA contributions in excess of the applicable limits. As a policy matter, it is inappropriate for taxpayers intentionally to make excess contributions. If the Roth IRA has significant investment returns, the annual six-percent excise tax under section 4973 may not provide adequate disincentive for making such contributions.

### **Proposal**

The proposal would increase the section 4973 excise tax for excess contributions to IRAs (including Roth and traditional IRAs). Under the proposal, the excise tax would remain at six percent for the taxable year for which an excess contribution is made but would be increased to ten percent for each subsequent taxable year.

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

## **PLACE LIMITATION ON PRE-FUNDING OF WELFARE BENEFITS**

### **Current Law**

Sections 419 and 419A generally limit the deduction available for contributions to welfare benefit funds used to fund and pre-fund welfare benefit expenses. Section 419A(f)(6) provides an exception to these deduction rules for amounts contributed to multiple employer welfare benefit funds that (i) have at least 10 employers, none of whom normally contributes more than 10 percent of the total contributions, and (ii) do not maintain experience rating arrangements with respect to individual employers. In 1995, Notice 95-34, 1995-1 C.B. 309 was issued informing taxpayers that certain severance pay and death benefit arrangements that did not satisfy the requirements of the section 419A(f)(6) exemption did not provide the deductions claimed by the promoters for a number of reasons. In 1997, the Tax Court ruled that an employer's deductions for contributions to certain of these arrangements were limited because the arrangements did not qualify as 10 or more employer plans. See *Robert D. Booth and Janice Booth v. Commissioner*, 108 T.C. No. 25 (1997). Several other cases are in progress.

### **Reasons for Change**

Sections 419 and 419A were enacted to limit abusive practices associated with the pre-funding of welfare benefits, and generally limit the prefunding of welfare benefits, including severance benefits and benefits provided pursuant to life insurance contracts. Congress permitted a limited exception to the general limitations for certain multiple employer welfare benefit funds with 10 or more participating employers where the relationship of participating employers would be closer to the relationship of insureds to an insurer than to the relationship of an employer to a fund.

Promoters have been aggressively marketing multiple employer welfare benefit funds that they claim qualify for the 10-or-more-employer exception, even though these arrangements lack the characteristics of insurance. In particular, the requirement of the exception that there not be experience rating with respect to participating employers has proven to be difficult to enforce with respect to certain types of benefits, such as severance and certain death benefits, because the complexities of the arrangements disguise experience rating. As a result, it appears that in many cases this requirement has effectively been ignored, and there has been extensive activity involving programs that rely on the expectation of each participating employer that its contributions will be used to fund or purchase benefits for its own employees.

The arrangements being promoted to high-income taxpayers sometimes are sold as alternatives to qualified retirement plans and are designed to avoid the deduction rules applicable to traditional welfare benefit and nonqualified deferred compensation arrangements, which would generally require that the deduction for the employer be deferred until benefits are paid. In many cases, these arrangements claim to offer employee-owners tax-deductible cash value life insurance, with the cash value to be transferred to the employee-owner at a later date. Thus, a participating employer (typically a closely held corporation owned by one or more high-income taxpayers) that contributes to such a

shelter arrangement is promised a current deduction for benefits to be paid to its employee-owners in the future, a deduction that has been foreclosed in most cases by other provisions of the Code.

### **Proposal**

The exception contained in section 419A(f)(6) would be limited to medical, disability, and group term life insurance benefits. These benefits do not present the same potential for abuse as severance pay and death benefits (other benefits paid through than group term life insurance). Thus, effective for contributions paid after the date of enactment, the existing deduction limits of the Code would apply to any plan if the plan provides benefits other than medical, disability and group term life insurance benefits. Thus, an employer would be prohibited from claiming a current deduction for severance pay, life insurance (other than group term life insurance), supplemental unemployment benefits, or other benefits in future years. In addition, rules would be added to prevent amounts deducted in accordance with the 10-or-more-employer exception of section 419A(f)(6), and earnings attributable to such amounts, from being used to pay benefits other than medical, disability or group term life insurance benefits. No inference should be drawn regarding the validity, if any, of these arrangements under current law.

The proposal would be effective with respect to contributions paid after the date of enactment.

## **SUBJECT SIGNING BONUSES TO EMPLOYMENT TAXES**

### **Current Law**

Bonuses paid to individuals for signing their first contracts of employment are ordinary income in the year received. However, IRS Revenue Ruling 58-145 provides that bonuses that do not require the performance of later services do not represent remuneration for services and thus are not “wages” for purposes of income tax withholding. Similarly, to the extent that a bonus payment is not remuneration for services, the bonus would not be “wages” for purposes of FICA taxes.

### **Reason for Change**

Withholding on signing bonuses could improve compliance and enforcement and eliminate the deferral of the tax payment. These bonuses are inextricably tied to the employment of the individual and are more appropriately treated as remuneration for services.

### **Proposal**

The proposal would impose income tax withholding on signing bonuses and clarify that signing bonuses are subject to other employment taxes, without regard to whether the bonus is conditioned on any additional action by the recipient. No inference is intended with respect to the application of prior law withholding rules to signing bonuses.

The proposal would be effective for signing bonuses paid after the date of enactment.

## **Compliance**

### **EXPAND REPORTING OF CANCELLATION OF INDEBTEDNESS INCOME**

#### **Current Law**

Taxable income includes income from the cancellation of indebtedness. If a bank, thrift institution, or credit union discharges \$600 or more of any indebtedness of a debtor, the institution must report such discharge to the debtor and the IRS.

#### **Reasons for Change**

A significant amount of indebtedness is originated and held by institutions in the trade or business of lending that are not banks, thrift institutions, or credit unions. Loans made and held by these nonregulated institutions resemble loans made by regulated institutions. Thus, it is appropriate that the reporting requirements imposed upon regulated lending institutions also should be applied to regulated lending institutions. Such additional reporting will facilitate tax compliance with respect to discharged loans.

#### **Proposal**

The proposal would extend the cancellation of indebtedness reporting requirements to additional entities involved in the trade or business of lending, effective for cancellations on or after the date of enactment.



## **TIGHTEN THE SUBSTANTIAL UNDERSTATEMENT PENALTY FOR LARGE CORPORATIONS**

### **Current Law**

Currently, taxpayers may be penalized for erroneous, but non-negligent, return positions only if the taxpayer did not have “substantial authority” for the claimed position, the taxpayer did not disclose the position in a statement or return, and the amount of the understatement is “substantial.” (Special rules apply in the case of tax shelters.) “Substantial” is defined for this purpose as the greater of \$5,000 (\$10,000 for certain corporations) or 10 percent of the taxpayer's total tax liability.

### **Reasons for Change**

Under the current definition of “substantial,” large corporations are allowed to have a very sizable understatement that does not exceed 10 percent of their total tax bill. This may encourage them to take very aggressive tax positions. In effect, they can “play the audit lottery” without any downside risk of a penalty if they are caught, even if huge amounts of potential tax liability are at stake.

### **Proposal**

The proposal would treat a corporation's deficiency of more than \$10 million as substantial for purposes of the substantial understatement penalty, whether or not it exceeds 10 percent of the taxpayer's total tax liability. This proposal should help to deter aggressive tax planning by large corporate taxpayers that have tax liabilities of \$100 million or more.

The proposal would be effective for taxable years beginning after the date of enactment.

## **REQUIRE WITHHOLDING ON CERTAIN GAMBLING WINNINGS**

### **Current Law**

Proceeds of most wagers with odds of less than 300 to 1 are exempt from withholding, as are all bingo and keno winnings.

### **Reasons for Change**

Withholding on gambling winnings would improve compliance and enforcement.

### **Proposal**

The proposal would impose withholding on proceeds of bingo or keno in excess of \$5,000 at a rate of 28 percent, regardless of the odds of the wager. The proposal would be effective for payments made after the beginning of the first month that begins at least 10 days after the date of enactment.

## **INCREASE PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS**

### **Current Law**

Any person who fails to file required information returns in a timely manner or incorrectly reports such information is subject to penalties. The amount of the penalty is generally \$50 for each return with respect to which a penalty is incurred, not to exceed \$250,000 during any calendar year. If any failure or error is corrected within 30 days after the required filing date, the penalty imposed is \$15 per return, not to exceed \$75,000. Failures corrected more than 30 days after the required filing date but before August 1 are subject to a \$30 per return penalty, not to exceed \$150,000 in any calendar year.

### **Reasons for Change**

For taxpayers filing large volumes of information returns or reporting significant payments, the general penalty provisions may not be sufficient to encourage timely and accurate reporting. By basing the penalty amount on either the number of returns or amount to be reported, the proposal encourages taxpayers to assure both the accuracy and timeliness of information on each return and in the aggregate.

### **Proposal**

The proposal would increase the general penalty amount for any failure to the greater of \$50 per return or 5 percent of the total amount required to be reported, subject to the overall dollar limitations. The increased penalty would not apply if the aggregate amount actually reported by the taxpayer on all returns filed for that calendar year was at least 97 percent of the amount required to be reported. The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment of the proposal.

## **Miscellaneous**

### **MODIFY DEPOSIT REQUIREMENT FOR FEDERAL UNEMPLOYMENT ACT (FUTA)**

#### **Current Law**

The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6.2 percent of the first \$7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. States also impose an unemployment tax on employers. Employers in States that meet certain federal requirements are allowed a credit for State unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent. Generally, federal and State unemployment taxes are collected quarterly and deposited in federal trust fund accounts.

#### **Reasons for Change**

Accelerating collections may reduce losses to the federal unemployment trust funds caused by employer delinquencies and provide a regular inflow of money into State funds to offset the regular payment of benefits. Limiting the application of acceleration to larger employers would avoid imposing additional burdens on small businesses.

#### **Proposal**

The proposal would require an employer to pay federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was \$1,100 or more (reflecting approximately 20 employees earning at least \$7,000). A safe harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer would be required to pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be allowed to provide a similar mechanism for paying State unemployment taxes.

The collection proposal would be effective for months beginning after December 31, 2004.

## **REINSTATE OIL SPILL LIABILITY TRUST FUND TAX**

### **Current Law**

Before January 1, 1995, a five-cents-per-barrel excise tax was imposed on domestic crude oil and imported petroleum products. The tax was dedicated to the Oil Spill Liability Trust Fund to finance the cleanup of oil spills and pay other costs associated with oil pollution. The tax was not imposed for a calendar quarter if the unobligated balance in the Trust Fund exceeded \$1 billion at the close of the preceding quarter.

### **Reasons for Change**

It is essential that the Oil Spill Liability Trust Fund remain funded because of the continuing potential for oil spills and the magnitude of damages such spills can cause. Moreover, the full funding level was last changed by the Omnibus Budget Reconciliation Act of 1989 and is no longer adequate. After the enactment of the current \$1 billion limitation, the Oil Pollution Act of 1990 permitted the use of amounts in the Trust Fund for additional expenditure purposes and doubled the limits on Trust Fund expenditures with respect to a single incident (increasing the overall limit from \$500 million to \$1 billion and the limit for natural resource damages payments from \$250 million to \$500 million). In addition, the Department of the Treasury's authority to advance up to \$1 billion to the Trust Fund expired in 1994.

### **Proposal**

The Oil Spill Liability Trust Fund excise tax would be reinstated for the period after the date of enactment and before October 1, 2009. In addition, the full funding limitation would be increased from \$1 billion to \$5 billion, effective on the date of enactment.

## **SIMPLIFY FOSTER CHILD DEFINITION UNDER EITC**

### **Current Law**

A taxpayer is eligible to claim the earned income tax credit (EITC) if he or she resides with a son, daughter, or grandchild for over half the year. EITC qualifying children also include foster children, defined to mean individuals who reside with a taxpayer for a full year and whom the taxpayer “cares for as the taxpayer’s own child.” All EITC qualifying children (including foster children) must either be under the age of 19 (24 if a full-time student) or permanently and totally disabled.

When more than one taxpayer can meet the eligibility criteria with respect to the same child, only the taxpayer with the highest modified adjusted gross income may claim the credit.

### **Reasons for Change**

The foster child rule is difficult to administer. For example, some taxpayers claim unrelated children for EITC purposes, by arguing that they lived with the child’s parent and “cared for the child as if the child was their own.” Without more objective standards regarding the definition of a foster child, the IRS cannot easily determine whether, in fact, these taxpayers are eligible for the EITC.

Clarifying the definition of a foster child would prevent unintentional errors by confused taxpayers, reduce potential abuse by noncompliant taxpayers, and provide better guidance to the IRS when investigating questionable claims.

### **Proposal**

In addition to the existing requirement that the foster child be a child who is cared for by the taxpayer as if he or she were the taxpayer’s own child, the proposal requires that a foster child, for purposes of claiming the EITC, also meet a specified relationship test. Under this test, the foster child must be the taxpayer’s sibling (or descendant of the taxpayer’s sibling), or be placed in the taxpayer’s home by an agency of a State or one of its political subdivisions or a tax-exempt child placement agency licensed by a State. The proposal would be effective for taxable years beginning after December 31, 1999.

## **REPEAL PERCENTAGE DEPLETION FOR NON-FUEL MINERALS MINED ON FEDERAL AND FORMERLY FEDERAL LANDS**

### **Current Law**

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to certain hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater depletion allowance for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property that is equal to the ratio of the units sold from that property during the taxable year to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The 1872 mining act has allowed investors to acquire mining rights on Federal lands at a cost of \$5.00 per acre or less.

### **Reasons for Change**

The percentage depletion provisions under current law generally are viewed as an incentive for mineral production rather than as a normative rule for recovering the taxpayer's investment in the property. This incentive is excessive, however, with respect to minerals acquired under the 1872 mining act, in light of the minimal costs of acquiring these mining rights. In addition, the measurement of income in the affected industries will be improved by the repeal of these percentage depletion provisions.

### **Proposal**

The proposal would repeal percentage depletion provisions under current law for non-fuel minerals mined on Federal lands where the mining rights were originally acquired under the 1872 law, and on private lands acquired under the 1872 law. The proposal would be effective for taxable years beginning after the date of enactment.

## **IMPOSE EXCISE TAX ON PURCHASE OF STRUCTURED SETTLEMENTS**

### **Current Law**

Current law facilitates the use of structured personal injury settlements by permitting a defendant to assign to a structured settlement company (“SSC”) the liability to make periodic payments to an injured person, such that the defendant can deduct the payment immediately, but the SSC does not include the amount received from the defendant in income. This favorable treatment is conditioned on a requirement that the periodic payments cannot be accelerated, deferred, increased or decreased by the injured person. If the SSC purchases a deferred annuity contract to fund the liability, it is exempted from the section 72(u) inclusion of inside buildup, and is subject to the more favorable rules of annuity taxation usually applicable only to individual owners. As a result, the income under the annuity is taxable to the SSC only upon receipt by the SSC, at which time the SSC is entitled to an offsetting deduction for corresponding payments to the injured person. The exclusion for physical personal injury damages applies also to amounts received periodically, thus effectively exempting the interest income in the hands of the injured person from tax as well.

### **Reasons for Change**

Congress enacted favorable tax rules intended to encourage the use of structured settlements --and conditioned such tax treatment on the injured person’s inability to accelerate, defer, increase or decrease the periodic payments --because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance.

Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, SSC agreements with injured persons uniformly contain anti-assignment clauses. Notwithstanding these contractual provisions, however, many injured persons are willing to accept heavily discounted lump sum payments from certain “factoring” companies in consideration for their payment streams. These “factoring” transactions directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims.

### **Proposal**

Under the proposal, any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 40 percent excise tax on the difference between the amount paid by the purchaser to the injured person and the undiscounted value of the purchased income stream, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original intended recipient render such a transaction desirable. The proposal would apply to purchases occurring after the date of enactment. No inference is intended as to the contractual validity of the factoring transaction or its effect on the tax treatment of any party other than the purchaser.



## **REQUIRE TAXPAYERS TO INCLUDE RENTAL INCOME OF RESIDENCE IN INCOME WITHOUT REGARD TO PERIOD OF RENTAL**

### **Current Law**

Gross income generally includes all income from whatever source derived, including rents. Section 280A provides rules for determining deductibility of expenses attributable to rental property. Section 280A(g) provides a *de minimis* exception to these rules where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no expenses arising from such rental use are allowed as a deduction.

### **Reasons for Change**

The 15-day rule allows certain taxpayers to exclude from income large rental payments for the short-term rental of the taxpayer's residence. Similar exclusions are not provided for other types of passive income such as interest, dividends or capital gains. Such amounts generally should be included in income of the taxpayers.

### **Proposal**

The proposal would repeal the 15-day rule of section 280A(g). Consequently, a taxpayer would be required to include in gross income the rental income received with respect to the rental of the residence without regard to the period of rental. The rules of section 280A would be applied to determine deductibility of expenses attributable to the rental of such property. The proposal would apply to taxable years beginning after December 31, 1999.

## **Other Provisions That Affect Receipts**

### **REINSTATE ENVIRONMENTAL TAX IMPOSED ON CORPORATE TAXABLE INCOME AND DEPOSITED IN THE HAZARDOUS SUBSTANCE SUPERFUND TRUST FUND**

#### **Current Law**

For taxable years beginning before January 1, 1996, a corporate environmental income tax was imposed at a rate of 0.12 percent on the amount by which the modified alternative minimum taxable income of a corporation exceeded \$2 million. Modified alternative minimum taxable income was defined as a corporation's alternative minimum taxable income, determined without regard to the alternative minimum tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax was dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

#### **Reasons for Change**

The corporate environmental income tax should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

#### **Proposal**

The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1998, and before January 1, 2010.

## **REINSTATE EXCISE TAXES DEPOSITED IN THE HAZARDOUS SUBSTANCE SUPERFUND TRUST FUND**

### **Current Law**

The following Superfund excise taxes were imposed before January 1, 1996:

(1) An excise tax on domestic crude oil and on imported petroleum products at a rate of 9.7 cents per barrel;

(2) An excise tax on listed hazardous chemicals at a rate that varied from \$0.22 to \$4.87 per ton; and

(3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2) above.

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the Superfund Trust Fund). Amounts in the Superfund Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund Trust Fund is classified as discretionary domestic spending for Federal budget purposes.

### **Reasons for Change**

The Superfund excise taxes should be reinstated because of the continuing need for funds to remedy damages caused by releases of hazardous substances.

### **Proposal**

The three Superfund excise taxes would be reinstated for the period after the date of enactment and before October 1, 2009.

**CONVERT A PORTION OF THE EXCISE TAXES DEPOSITED IN THE  
AIRPORT AND AIRWAY TRUST FUND TO COST-BASED USER FEES ASSESSED  
FOR FEDERAL AVIATION ADMINISTRATION (FAA) SERVICES**

**Current Law**

The Airport and Airway Trust Fund is supported by taxes on air passenger transportation, domestic air freight transportation, and aviation fuel. The current tax on domestic air passenger transportation is 8 percent of the amount paid for the transportation plus \$2.00 for each segment of the transportation, the current tax on international departures and arrivals is \$12.20 per person, and the tax on domestic air freight transportation is 6.25 percent of the amount paid for the transportation. The rate of tax on amounts paid for domestic air transportation is phased down to 7.5 percent after September 30, 1999. The domestic segment fee is phased up in four steps to a fully phased-in fee of \$3.00 per segment after December 31, 2001. In addition, the segment fee is indexed for inflation beginning in calendar year 2003 and the international arrival and departure fees are currently indexed for inflation. The tax on aviation fuel, to the extent dedicated to the Trust Fund, is 4.3 cents per gallon in the case of commercial aviation fuel, 19.3 cents per gallon in the case of gasoline used in noncommercial aviation, and 21.8 cents per gallon in the case of noncommercial aviation fuel other than gasoline.

**Reasons for Change**

As part of the Administration's effort to create a more business-like Federal Aviation Administration, the excise taxes on domestic air passenger transportation, international departures and arrivals, and domestic air freight transportation should be reduced and cost-based user fees imposed.

**Proposal**

The Administration will propose legislation to reduce the excise taxes on domestic air passenger transportation, international departures and arrivals, and domestic air freight transportation as more efficient cost-based user fees for air traffic services are phased in beginning in fiscal year 2000. The excise taxes would be reduced as necessary to ensure that the amount collected each year from the new user fees and from the excise taxes dedicated to the Airport and Airway Trust Fund is, in the aggregate, equal to the total budget resources requested for the FAA in the succeeding year.

## RECEIPTS FROM TOBACCO LEGISLATION

### Current Law

The following is a listing of the Federal excise taxes imposed on tobacco products under current law:

<u>Calendar year</u>	<u>Article</u>	<u>Tax imposed</u>
1999	Cigars:	
	Small cigars . . . . .	\$1.125 per thousand
	Large cigars . . . . .	12.75% of manufacturer's price, up to \$30.00 per thousand
	Cigarettes:	
	Small cigarettes . . . . .	\$12.00 per thousand (24 cents per pack of 20 cigarettes)
	Large cigarettes . . . . .	\$25.20 per thousand
	Cigarette papers . . . . .	\$0.0075 per 50 papers
	Cigarette tubes . . . . .	\$0.015 per 50 tubes
	Chewing tobacco . . . . .	\$0.12 per pound
	Snuff . . . . .	\$0.36 per pound
	Pipe tobacco . . . . .	\$0.675 per pound
2000 and 2001	Cigars:	
	Small cigars . . . . .	\$1.594 per thousand
	Large cigars . . . . .	18.063% of manufacturer's price, up to \$42.50 per thousand
	Cigarettes:	
	Small cigarettes . . . . .	\$17.00 per thousand (34 cents per pack of 20 cigarettes)
	Large cigarettes . . . . .	\$35.70 per thousand
	Cigarette papers . . . . .	\$0.0106 per 50 papers
	Cigarette tubes . . . . .	\$0.0213 per 50 tubes
	Chewing tobacco . . . . .	\$0.17 per pound
	Snuff . . . . .	\$0.51 per pound
	Pipe tobacco . . . . .	\$0.9567 per pound
	Roll-your-own tobacco . . . . .	\$0.9567 per pound
2002 or later	Cigars:	
	Small cigars . . . . .	\$1.828 per thousand
	Large cigars . . . . .	20.719% of manufacturer's price, up to \$48.75 per thousand
	Cigarettes:	
	Small cigarettes . . . . .	\$19.50 per thousand (39 cents per pack of

	20 cigarettes)
Large cigarettes . . . . .	\$40.95 per thousand
Cigarette papers . . . . .	\$0.0122 per 50 papers
Cigarette tubes . . . . .	\$0.0244 per 50 tubes
Chewing tobacco . . . . .	\$0.195 per pound
Snuff . . . . .	\$0.585 per pound
Pipe tobacco . . . . .	\$1.0969 per pound
Roll-your-own tobacco . . . . .	\$1.0969 per pound

**Reasons for Change**

The Federal government incurs substantial amounts of tobacco-related health care costs. The burden of these costs should be borne by the tobacco industry and tobacco users rather than by taxpayers generally.

**Proposal**

The Administration will propose tobacco legislation providing for net revenues of approximately \$34 billion during the period from October 1, 1999, through September 30, 2004.